THE NEW FUND OF FUNDS RULE AND ETFS—(MISSED) OPPORTUNITIES

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U.S. Asset Management and Investment Funds Alert

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The SEC recently adopted Rule 12d1-4 (Rule 12d1-4 or Rule) under the Investment Company Act of 1940 (1940 Act) to streamline the regulatory framework applicable to registered funds that invest in other funds (funds of funds).[1] In our 26 October 2020 alert, entitled *SEC Adopts New Rule 12d1-4 Overhauling Fund of Funds Arrangements -- Are you Ready?* (General FOF Alert), we explained the Rule in detail and identified its key ramifications for the fund industry as a whole.[2] This alert focuses specifically on how the Rule will affect exchange-traded fund (ETFs) and will be followed by a third alert, which will address the impact of the Rule on closed-end funds and business development companies.

This alert begins by providing background on the role ETFs have historically played in fund of funds structures and outlines the regulatory requirements applicable to them in that role. It then outlines Rule 12d1-4 and explains how the Rule changes, and lessens, the regulatory burden on ETFs in funds of funds structures. Finally, it considers where Rule 12d1-4 may have missed the mark for ETFs, including where the Rule could have—and arguably should have—gone farther to facilitate other funds' ability to invest in ETFs.

BACKGROUND

ETFs did not exist prior to 1993. Rather, retail investors largely invested in mutual funds and, to a lesser extent, closed-end funds. This principally resulted from the fact that the 1940 Act does not allow for the operation of ETFs, which require exemptive relief from the U.S. Securities and Exchange Commission (SEC) to operate legally.

In 1993, the SEC granted the first ETF exemptive order.[3] From 1993 to 2000, the SEC granted approximately a dozen additional ETF orders.[4] In the last 20 years, however, the SEC has granted more than 300 orders,[5] and ETFs have arguably emerged as the investment vehicle of twenty-first century, which the SEC acknowledged in December 2019 with the adoption of the ETF Rule, Rule 6c-11 under the 1940 Act.[6]

Because ETFs, until 2020, required an SEC exemptive order to operate, much of how they have historically operated can be connected to the permissions granted to them in their SEC exemptive orders. This is also true of the role that ETFs tend to play in fund of funds arrangements.

In fund of funds arrangements, one fund (acquiring fund) acquires shares of another fund or funds (acquired fund). SEC fund of funds exemptive gave ETFs relief from Section 12(d)(1) to operate as acquired funds. Such relief permitted acquiring funds to purchase ETF shares in excess of the 3/5/10 Limits (defined below) of Section 12(d)(1) and permitted ETFs to sell their shares to acquiring funds in such amounts. The relief allowed ETFs to serve as trading vehicles (FOF ETF Relief).

ETFs understood that, due to their exchange-traded nature, they could be used by institutional and other investors (including other registered funds) to equitize cash and obtain long- or short-term exposures. Thus, ETFs sought fund of funds exemptive relief from the earliest days of the ETF industry to keep Section 12(d)(1) from discouraging other funds from using them for these purposes in light of, among other things, their original index-based nature. As a result, ETFs became a prevalent type of acquired fund in fund of funds structures.

HISTORICAL REGULATORY REQUIREMENTS FOR ETFS IN FUNDS OF FUNDS

As explained in our General FOF Alert and as relevant here, Section 12(d)(1)(A) of the 1940 Act prohibits an acquiring fund from acquiring shares of an acquired fund, if immediately after such purchase the acquiring fund would own more than 3 percent of the total outstanding voting stock (shares) of the acquired fund, or more than 5 percent of the acquiring fund's assets would be invested in the acquired fund, or more than 10 percent of the acquiring fund's assets would be invested in other investment companies in the aggregate. These are commonly referred to as the “3/5/10 Limits.” Section 12(d)(1)(B) places parallel prohibitions on the sale of shares by open-end acquired funds to acquiring funds with respect to the 3 percent limit, and also restricts an open-end acquired fund from selling shares to an acquiring fund if more than 10 percent of the acquired fund's shares are owned by other investment companies.

Section 12(d)(1) imposes these limits on funds' investments in other funds to prevent pyramided fund structures, which the SEC and Congress determined raise three policy concerns:

- Abusive control relationships where acquiring funds could control a shareholder vote at the acquired fund or exercise undue influence by threatening to redeem a large position.
- Excessive and/or duplicative management and other fund fees.
- Overly complex fund structures that confused investors about what they owned or how their investment should perform.[7]

In 1996, however, Congress created certain carve-outs (i.e., statutory exemptions) to the Section 12(d)(1) restrictions.[8] Specifically, Congress adopted Section 12(d)(1)(G) of the 1940 Act, which exempts funds in the same “group of investment companies” from Sections 12(d)(1)(A) and (B).[9] These funds may invest without limit in each other, provided that any acquiring fund in a Section 12(d)(1)(G) arrangement does not also act as an acquired fund in such an arrangement.[10]

Thereafter, the SEC also moved to loosen the restrictions imposed by Sections 12(d)(1) on funds of funds. In particular, the SEC began to issue exemptive orders granting funds of funds relief, including FOF ETF Relief, from various of the 12(d)(1) restrictions.

As explained above, in FOF ETF Relief, ETFs obtain exemptive relief from Section 12(d)(1) to permit acquiring funds, which are not in the same group of investment companies as acquired funds, to purchase such acquired funds' shares in excess of the 3/5/10 Limits and to permit the acquired funds to sell their shares to acquiring funds in such amounts. Further, FOF ETF Relief exempts funds from Section 17(a) of the 1940 Act to permit acquiring funds that are first- or second-tier affiliates of the ETFs, solely by virtue of owning more than 5 percent of the ETF's or an affiliated fund's shares, to engage in in-kind creation unit transactions with the ETFs.[11] Relief has not extended to affiliates' secondary market purchases and sales of ETF shares because relief is not required for such transactions.[12] In addition, the relief has not extended to first- or second-tier affiliates of ETFs that are affiliated by virtue of both funds being advised by a common or affiliated adviser (e.g., same group acquiring funds) because such relief is available under Section 12(d)(1)(G), as discussed above.

Notwithstanding the multiplicity of ETF orders issued over the last 27 years, the conditions imposed by them on ETFs that serve as acquired funds have been consistent.[13] The conditions for all types of ETFs, including transparent and semi-transparent ETFs, have been as follows:[14]

Conditions in SEC Exemptive Orders
Required Findings. Once an acquiring fund owns more than 3 percent of an acquired fund's shares, the acquired fund board must determine that any consideration paid by it to the acquiring fund or its affiliates is fair and reasonable based on the services received, is within the range of consideration it would have had to pay a third party for similar services, and does not involve overreaching. Once an acquiring fund owns more than 3 percent of an acquired fund's shares, the acquired fund board must adopt procedures to monitor purchases by the acquired fund in any underwriting in which an acquiring fund affiliate is a member of the underwriting syndicate and review whether such purchases are consistent with the acquired fund's investment objective, how the purchased securities perform compared to comparable securities in which the acquired fund could have invested, and whether the amount of securities has varied materially from year to year.
Required Agreement. A Participation Agreement between acquiring and acquired funds must be executed whereby such funds agree to fulfill their responsibilities under the exemptive order and the acquiring fund agrees to (1) notify the acquired fund prior to an investment in excess of the 3/5/10 Limits and (2) provide the acquired fund a list of acquiring fund affiliates.
Three-tiered Arrangements. Acquired funds may invest in other funds within the 3/5/10 Limits and consistent with certain enumerated exceptions to the 3/5/10 Limits.

These conditions appropriately addressed the concerns underlying Section 12(d)(1) discussed above—namely, undue influence, layering of fees and complexity. Nonetheless, Rule 12d1-4 will replace these conditions with new conditions that will apply to all funds, including ETFs.

THE REGULATION OF ETFS IN FUNDS OF FUNDS UNDER RULE 12D1-4

The impact of Rule 12d1-4 on ETFs is best analyzed by comparing the Rule's various conditions with those contained in prior SEC fund of funds exemptive orders. The table below provides a side-by-side comparison of the conditions imposed on ETFs as acquired funds under prior exemptive orders and under Rule 12d1-4.[15]

Conditions in SEC Exemptive Orders	Conditions in Rule 12d1-4
Required Findings. Once an acquiring fund owns more than 3 percent of an acquired fund's shares, the acquired fund board must determine that any consideration paid by it to the acquiring fund or its affiliates is fair and reasonable based on the	**Required Findings.** The adviser of an acquired management company, including an acquired ETF, must: (1) find that any undue influence concerns associated with the acquiring fund's investment in the acquired fund are reasonably addressed, after

services received, is within the range of consideration it would have had to pay a third party for similar services, and does not involve overreaching. In addition, the acquired fund board must adopt procedures to monitor purchases by the acquired fund in any underwriting in which an acquiring fund affiliate is a member of the underwriting syndicate and review whether such purchases are consistent with the acquired fund's investment objective, how the purchased securities perform compared to comparable securities in which the acquired fund could have invested, and whether the amount of securities has varied materially from year to year.	considering certain specific factors; and (2) report such evaluation, finding, and basis for its evaluations and findings to the board no later than the next regularly scheduled board meeting. Factors include: (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 investment 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 redemptions in kind (Factors).
Required Agreement. A Participation Agreement between acquiring and acquired funds must be executed whereby such funds agree to fulfill their responsibilities under the exemptive order and the acquiring fund agrees to (1) notify the acquired fund prior to an investment in excess of the 3/5/10 Limits and (2) provide the acquired fund a list of acquiring fund affiliates.	**Required Agreement.** A Fund of Funds Investment Agreement between acquiring and acquired funds must be executed, unless the funds have the same adviser, which includes: (1) any material terms necessary for each adviser to make the appropriate finding under the rule; (2) a termination provision; and (3) a requirement that the acquired fund provide fee and expense information to the acquiring fund.
Three-tiered Arrangements. Acquired funds may invest in other funds within the 3/5/10 Limits and consistent with certain enumerated exceptions to the 3/5/10 Limits.	**Three-tiered Arrangements**. Acquired funds may not invest more than 10 percent of net assets in other funds, including private funds, except pursuant to certain enumerated exceptions.

Required Findings

Under existing exemptive orders, acquired fund *boards* must make certain findings to oversee the potential for overreaching and undue influence by an *acquiring fund* and its affiliates. Rule 12d1-4 changes this requirement in several ways.

- First, Rule 12d1-4 broadens this requirement to apply to *all* funds of funds—not just ones involving an acquiring fund that is unaffiliated and/or not in the same group of investment companies.[16]
- Second, it shifts the burden of making the finding from the board to the acquired fund's adviser.
- Third, the finding required under Rule 12d1-4 becomes “that any undue influence concerns associated with the acquiring fund's investment in the acquired fund are reasonably addressed.”

- Fourth, in making the finding, the acquired fund's adviser must consider at a minimum the Factors (discussed above).

Factor (4) (from the first line of the table above) should allow advisers of all ETFs that reasonably expect to, or are simply able to, honor redemptions in kind to make the requisite finding. In addition, to the extent an ETF transacts in creation units on a T-1 basis,[17] it would always have advance notice of a redemption request, which its adviser could consider in fulfillment of factor (3). In short, ETF advisers should largely be able to make the findings required by Rule 12d1-4 and, in that respect, it likely eases ETFs' regulatory burdens.

Required Agreement

Under Rule 12d1-4, unless an acquiring fund's investment adviser or sub-adviser acts as the acquired fund's investment adviser, the acquiring fund and acquired fund must enter into an agreement (Fund of Funds Investment Agreement) before the acquiring fund exceeds the 3/5/10 Limits. The Fund of Funds Investment Agreement is a riff on the agreement required by SEC exemptive orders between acquiring and acquired funds, the "Participation Agreement."[18] Our General FOF Alert details the differences that the SEC envisions between Participation Agreements and Fund of Funds Investment Agreement.[19]

Two differences are noteworthy for ETFs. First, the SEC intends for the Fund of Funds Investment Agreement to memorialize the material terms negotiated between the acquiring and acquired funds, including tailored terms specific to the arrangement. Unfortunately, the more bespoke nature of the agreement envisioned by Rule 12d1-4 will likely impose additional costs on funds, as Participation Agreements have become uniform over the years and not open to extensive negotiation. In addition, what one adviser considers necessary to making findings, another may not; under such circumstances, the fund with less market power may be forced to "reconsider" its need for the information. The pressure will be particularly intense on acquired funds, often ETFs, that are anxious for a substantial investment from acquiring funds.

Second, the Adopting Release includes the following suggestion for ETFs regarding their compliance with Section 12(d)(1)(B) and, presumably, Rule 12d1-4:[20]

> ETFs that receive inquiries and other communications from persons identifying themselves as potential purchasers of the ETF's shares by or through an authorized participant may want to consider adopting and implementing policies and procedures to determine whether those persons intend to purchase ETF shares for investment companies. Further, principal underwriters and broker-dealers that transact in an ETF's shares (including an ETF's authorized participants) are subject to the requirements of Section 12(d)(1)(B).

This suggestion is puzzling because ETFs, generally speaking, do not "take calls" from potential purchasers of their shares. Rather, their principal underwriters, market makers and/or authorized participants do. Accordingly, it is unclear what policy or procedure an ETF would adopt to this end. The SEC appears to recognize this later in the Adopting Release and advises, "[A]n ETF that explains its obligations pursuant to section 12(d)(1)(B) to potential purchasers who reach out directly to the ETF, 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 the 12(d)(1)(B) limits."[21] In short, it seems that an ETF can at least partially fulfill its Rule 12d1-4 compliance obligations by including an explanation of its Section 12(d)(1)(B) limits and responsibilities in its distribution and authorized participant agreements and in its written correspondence with its lead market maker; and, otherwise, to the extent it does have a capital markets desk that interacts directly with investors, it will need to develop policies and procedures as suggested in the Adopting Release.

Three-tiered Arrangements

Under both past SEC exemptive orders and under Rule 12d1-4, the ability of acquired funds to invest in other funds is limited. Specifically, under prior SEC exemptive orders, acquired funds had three options:

- invest in other funds within the 3/5/10 Limits;
- invest in other funds within certain enumerated exceptions to the 3/5/10 Limits (Enumerated Exceptions);[22] and
- *to the extent that the acquiring fund invested in the acquired fund in reliance on Section 12(d)(1)(G)*, then the acquired fund *could no*t also invest in funds in reliance on Section 12(d)(1)(G) due to the statutory restriction noted above, but many fund groups took the position that the acquired fund *could* invest in ETFs in reliance on ETFs' SEC exemptive orders because Section 12(d)(1)(G) does not preclude such a structure in reliance on exemptive terms.[23]

Rule 12d1-4 forecloses the third of these options. Under Rule 12d1-4, acquired funds in Section 12(d)(1)(G) arrangements will no longer be able to acquire up to 25 percent of an ETF's shares under its exemptive order. Rather, all acquired funds will be limited to investing up to 10 percent of their assets in other funds, outside of the Enumerated Exceptions. As a result, certain acquired funds currently using an ETF's exemptive order to achieve their investment objectives may need to restructure.

Section 17(a) Relief for Affiliated Acquiring Funds to Transact in ETF Shares

As explained above, ETFs have historically obtained exemptive relief from Section 12(d)(1) and from Section 17(a) to permit them, as acquired funds, to sell their shares to and redeem their shares from acquiring funds that are first- and second-tier affiliates, solely by virtue of owning 5 percent or more, or more than 25 percent, of the shares of the ETF or an affiliated fund. Prior relief has allowed first- and second-tier affiliates also to engage in in-kind creation unit transactions with the ETF as an alternative to purchasing and selling the ETF shares in the secondary market. The relief has not allowed such transactions between ETFs and acquiring funds that are first- or second-tier affiliates by virtue of both funds being advised by a common adviser or affiliated advisers.

The text of the Adopting Release makes it clear that the SEC sought to codify in Rule 12d1-4 this relief.[24] It is also implied from the text and structure of Rule 12d1-4(a). However, as a textual matter, Rule 12d1-4(a) goes farther inasmuch as Rule 12d1-4(a)(1) and (2) provide, in fact, a complete exemption from Section 17(a).[25] Stated differently, even if Rule 12d1-4(a)(3) did not exist, Rule 12d1-4(a)(1) and (2) arguably permit all types of affiliates of all types of registered funds to transact with such funds in kind. In this regard, there is a gap between the Adopting Release and the Rule; and in most practitioners' experience, the Rule itself will control.

OPPORTUNITIES AND MISSED OPPORTUNITIES FOR ETFS IN 12D1-4

Missed Opportunity: ETFs as Acquired Funds

The 3/5/10 Limits apply to investments by both registered and unregistered investment companies in registered funds of all types.[26] However, these limits should not apply with equal force to investments in ETFs. Funds of all types should be able to invest in ETFs even more expansively than they can invest in any other type of fund and than they can under Rule 12d1-4 (i.e., effectively up to 25 percent of an ETF). This is the case because the policy concerns that underlie Section 12(d)(1) and that Rule 12d1-4 seeks to address—namely, undue influence, layering of fees and complex structures—are not wholly applicable to ETFs due to their operational and structural differences as compared to other funds.

ETFs are not susceptible to undue influence in the same way that traditional mutual funds and closed-end funds may be.[27] As a result of their embedded arbitrage mechanism, it is not profitable for any one investor or any group of investors to seek to exert influence over an ETF, either through voting or threatening large redemptions. With respect to the potential for undue influence through voting, unlike listed closed-end funds, ETFs are not required to—and normally do not—hold annual shareholder votes. Accordingly, buying shares in order to vote oneself in as a director or in order to install oneself as a fund service provider is futile.[28] In addition, buying shares to threaten large redemptions is futile because ETFs are designed to accommodate large redemptions (i.e., creation units). In particular, they are designed to accommodate large redemptions in kind, which allows them to avoid concerns about having to sell portfolio positions in “fire sales,” and the permission granted to ETFs under Rule 6c-11 to transact in custom baskets has further enhanced ETFs' ability to avoid being unduly influenced by large redemption requests.[29] Further, ETFs ordinarily charge transaction fees to investors who engage in creation unit transactions, and such fees cover the ETF's expenses in processing the order for the benefit of the ETF's remaining shareholders. In short, allowing ETFs to be used more broadly as acquired funds would not result in their being subject to material undue influence.

With respect to concerns about layering of fees through acquired funds, ETFs are generally significantly less expensive investments relative to other investment vehicles, including mutual funds and private funds. In fact, the low fee structure of ETFs has been credited (or blamed) for the broader decline in advisory fee levels and total expense ratios paid by investors over the last decade.[30] Accordingly, although allowing ETFs to be used more broadly as acquired funds would not reduce the number of layers of fees (i.e., the presence of acquired fund fees and expenses) for acquiring funds, it would likely reduce the absolute amount of layered fees for investors in funds of funds. Indeed, to the extent that Rule 12d1-4 forces funds of funds to invest in other, more expensive types of investment vehicles to seek a desired exposure, it very well could increase the absolute amount of layered fees rather than reduce them.

Further, any concerns about structural complexity should not prevent all types of funds from investing more broadly in ETFs than is permitted by Rule 12d1-4. The vast majority of ETFs are fully transparent—meaning they make their full portfolio holdings available on a daily basis,[31] and any additional flexibility included in the rule for ETFs could readily have been limited to fully transparent ETFs. Thus, the argument that allowing funds to invest in greater amounts in ETFs would increase structural complexity is not entirely convincing.

Rule 12d1-4's conservative approach to the fund of ETFs appears to be largely driven by the SEC's desire to establish a uniform approach to all types of registered funds, regardless of their distinguishing characteristics.[32] In this regard, the Adopting Release states, “[T]he final rule will treat ETFs consistently with other open-end funds.” While there is some logic to this approach, ETF sponsors may (not unreasonably) be concerned that this outcome was wrongly influenced by concerns that treating ETFs differently would create an unlevel playing field,[33] even though any unevenness would plainly be a function of operational and structural differences between ETFs and other funds.

Opportunity: ETFs as Acquiring Funds

The Rule will allow ETFs to invest in unlisted closed-end funds and unlisted business development companies beyond the limits in Section 12(d)(1).[34] This is an expansion of the exemptive relief that has been granted by past SEC orders: such orders have limited acquiring funds, including ETFs, to investing only in closed-end funds and business development companies whose shares are listed on a national securities exchange. Whether this expansion of past relief will lead to new ETF offerings will depend in large part on several factors. First, ETF sponsors will need to identify or develop marketable investment strategies that incorporate these investment types.[35] Any such strategies also must limit illiquidity, as unlisted closed-end funds and BDCs would be illiquid assets. Because unlisted closed-end funds and business development companies also will presumably not be readily available to market makers and authorized participants on an intra-day basis, they will need to find substitutes to hedge any position they hold in ETFs' shares.[36]

CONCLUSION

Rule 12d1-4 will provide significant benefits to ETFs. In particular, the burden of making required findings now resides with the ETF's adviser and not its board. In addition, there are some new opportunities for ETFs as acquiring funds to invest in unlisted closed-end funds and business development companies. Conversely, the Fund of Funds Investment Agreement required under Rule 12d1-4 will require a rethink of Participation Agreements, which may be costly for ETFs and result in uneven treatment of ETFs in the industry. Worse, the SEC missed an opportunity to embrace the structural and operational differences of ETFs that warrant their receiving more expansive relief from Section 12(d)(1) to operate as acquired funds both to traditional (registered) acquiring funds and to foreign and private funds.

FOOTNOTES

1 Fund of Funds Arrangements, SEC Release Nos. 33-10871 & IC-34045 (Oct. 7, 2020) (Adopting Release).

2 See *SEC Adopts New Rule 12d1-4 Overhauling Fund of Funds Arrangements--Are You Ready*? (Oct. 26, 2020), available here.

3 *In the Matter of SPDR Trust Series 1*, Investment Company Act Release No. 19055 (Oct. 26, 1992).

4 *E.g., In the Matter of CountryBaskets Index Fund, Inc., et al.*, Investment Company Act Release No. 21802 (Mar. 5, 1996).

5 See https://www.sec.gov/rules/icreleases.shtml#etf-active (SEC web page listing all ETF exemptive orders granted since 2007).

6 The SEC recently adopted Rule 6c-11 under the 1940 Act to permit the operation of ETFs. See Exchange-Traded Funds, 84 Fed. Reg. 57,162 (Oct. 24, 2019). As a result, most ETFs should no longer need an SEC exemptive order to begin operation and the vast majority of SEC ETF exemptive orders will be rescinded as of 23 December 2020. Nevertheless, the SEC did not rescind fund of funds orders granted to ETFs under Section 12(d)(1). Instead, the SEC has now taken such action by adopting Rule 12d1-4. As a result, after the effective

date of Rule 12d1-4, the vast majority of all fund of funds orders previously issued by the SEC to ETFs will be rescinded in their entirety.

[7] H.R. Rep. No. 89-2337, Ch. VIII § B, at 311-322 (1966).

[8] *See* National Securities Market Improvements Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 codified as 15 U.S.C. 80a-12(d)(1)(G)).

[9] Section 12(d)(1)(G) defines the term "group of investment companies" as "any 2 or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services."

[10] Section 12(d)(1)(G)(ii) in fact precludes any acquired fund from investing in other funds in reliance on any statutory exemption from Section 12(d)(1). Besides Section 12(d)(1)(G), there is one other statutory exemption. For simplicity, the alert does not discuss it, but it should be noted that acquired funds cannot invest in reliance on either statutory exemption.

[11] Pursuant to Rule 6c-11, ETFs are registered open-end management companies: (A) that issues (and redeems) creation units to (and from) authorized participants in exchange for a basket and a cash balancing amount if any; and (B) whose shares are listed on a national securities exchange and traded at market-determined prices. See 17 CFR § 270.6c-11.

[12] *E.g., WicShares Trust and Water Island Capital, LLC*, Investment Company Act Release No. 812-15039 (Aug. 8, 2019).

[13] The discussion herein regarding FOF ETF Relief pertains exclusively to acquiring funds and acquired funds (i.e., ETFs) that are registered under the 1940 Act and that are not in the same group of investment companies, as defined in Section 12(d)(1)(G)(i)(II). *See supra* note 9 (providing definition of same group of investment companies). *See also* Adopting Release at 17-18.

[14] The table is based loosely on that in Appendix A of our General FOF Alert. This table, however, excludes details that are not relevant specifically to ETFs serving as acquired funds. Please refer to the General FOF Alert for a complete list of the conditions in prior SEC exemptive orders.

[15] *Id.* (directing readers to Appendix A of our General FOF Alert for a more complete comparison the conditions imposed by prior SEC exemptive orders to the conditions imposed under Rule 12d1-4). These conditions will pertain to all types of ETFs, including transparent and semi-transparent ETFs. *See* Adopting Release at 15.

[16] *See supra* note 13. Notably, same group funds of funds that rely entirely on 12(d)(1)(G) will not be subject to this finding requirement, as it does not appear in the statute itself.

[17] *See* 17 CFR § 270.6c-11(c).

[18] Rule 12d1-4 shifts the focus for this purpose from whether funds are in the same group of investment companies to whether they have the same (or an affiliated) adviser. As a practical matter, this shift may be largely irrelevant as most funds that are in the same group have affiliated advisers and vice versa.

[19] *See supra* note 2. The SEC believes that Fund of Funds Investment Agreements differ in certain ways from participation agreements required under most of the SEC's fund of funds exemptive orders. Participation agreements under such orders require both funds in a fund of funds arrangement (and their investment advisers)

to fulfill their responsibilities under the order and, as such, participation agreements can vary. Participation agreements also require that the acquiring fund notify the acquired fund prior to investing in excess of the limits of Section 12(d)(1)(A) and provide the acquired fund a list of the names of each of its affiliates to help the acquired fund ensure compliance with the affiliated transaction provisions of the 1940 Act. However, because all funds operating in accordance with Rule 12d1-4 will be required to comply with its conditions, the SEC determined that Rule 12d1-4 will not require that a Fund of Funds Investment Agreement include these types of contractual provisions. Instead, a Fund of Funds Investment Agreement will be required to memorialize the terms of the arrangement that serve as a basis for the required fund findings described above. The SEC believes this approach may enable funds to tailor various terms of a Fund of Funds Investment Agreement to their specific arrangements and thereby provide greater protection against undue influence.

[20] Adopting Release at 17.

[21] Adopting Release at note 44.

[22] Historically, the enumerated exceptions have allowed acquired funds to invest in the securities of another fund that is: (i) acquired in reliance on section 12(d)(1)(E) of the 1940 Act (i.e., master-feeder arrangements); (ii) acquired pursuant to rule 12d1-1; (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 SEC to engage in interfund borrowing and lending transactions. *See* Adopting Release at 112.

[23] *See supra* note 10.

[24] *See* Adopting Release at Section II.B.

[25] *See* Rule 12d1-4(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), 262 12(d)(1)(C), 17(a), 57(a)(1)-(2), and 57(d)(1)-(2) of the Act (15 U.S.C. 80a 12(d)(1)(A), 80a12(d)(1)(C), 80a 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); (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.").

[26] Section 12(d)(1) also applies to registered funds' investments in unregistered investment companies (such as foreign funds not meeting an exception from the definition of investment company). *See* Adopting Release at note 14.

[27] Exchange-Traded Funds, SEC Release Nos. 33-10695 & IC-33646 (Dec. 23, 2019). *See also* Comment Letter of WisdomTree Asset Management, Inc. (Dec. 12, 2019) (commenting on then-proposed Rule 12d1-4).

[28] *But see* Adopting Release at 16 and 24 (contending that activist investors could somehow take these actions).

[29] *But see id.* (contending that ETFs are somehow more susceptible to such undue influence in the context of creation unit transactions).

[30] *See* Karen Demasters, *Investors Saved Nearly $6B Due To Declining Fund Fees In 2019, Morningstar Says*, Financial Advisor (June 9, 2020); *see also* Ryan Vlastelica, *Here's how much ETF fees have dropped since the financial crisis*, MarketWatch (May 19, 2017).

[31] *See* § 270.6c-11(c)(1)(i)(A)-(E).

[32] The SEC states that it declined to make additional allowances for ETFs as acquired funds simply because, as an agency, the SEC does not have experience with such arrangements. *See* Adopting Release at note 55 and surrounding text (SEC contending that this is a basis for declining to consider broader relief for ETFs and noting that an exemptive order may be pursued for such arrangements). This is not entirely persuasive, however, because in other provisions of the Rule, the SEC does grant exemptive relief that has never previously been granted. *See* Adopting Release at 13. Still, it is noteworthy that, notwithstanding the limits imposed on ETFs as acquired funds in Rule 12d1-4, the SEC appears to be genuinely interested in considering exemptive relief to permit broader investments in ETFs. *See* Adopting Release at 23.

[33] *Cf.* Adopting Release at note 203 and surrounding text.

[34] *See* Adopting Release at note 32 and surrounding text.

[35] Under Rule 6c-11, ETFs are able to invest in unlisted closed-end funds and business development companies.

[36] *See generally* Exchange-Traded Funds, SEC Release Nos. 33-10695 & IC-33646 (Dec. 23, 2019) (explaining why ETF market makers and authorized participants must be able to hedge their positions in ETF shares in order to make an efficient market in them).

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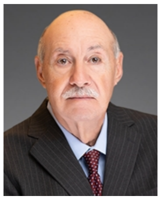

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