SEC PROPOSES A NEW RULE FOR FUND OF FUNDS ARRANGEMENTS

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U.S. Investment Management Alert

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I. EXECUTIVE SUMMARY

On December 19, 2018, the Securities and Exchange Commission (the "SEC") proposed new rule 12d1-4 (the "Proposed Rule") under the Investment Company Act of 1940, as amended (the "1940 Act") in order to "streamline" the regulatory framework applicable to fund of funds arrangements. The Proposed Rule would very significantly reorder fund of funds rules. The Proposed Rule would permit a fund to acquire shares of another fund (even if not in the same fund group) in excess of the 3/5/10 limits in Section 12(d)(1) of the 1940 Act without obtaining an exemptive order from the SEC, subject to a tailored set of conditions. The SEC's stated idea is that a comprehensive, uniform framework would reduce confusion, and subjecting fund of funds arrangements to a tailored set of conditions would enhance investor protection. [1]

As the Proposed Rule would provide a comprehensive exemption for fund of funds arrangements, the SEC is also proposing to rescind Rule 12d1-2 under the 1940 Act and, significantly, individual exemptive orders (of which there are many) for fund of funds arrangements. This may significantly affect many existing fund of funds, and for "affiliated fund of funds," which invest directly in securities in addition to other funds, would, in effect, force such affiliated fund of funds to rely on the Proposed Rule or give up direct investments. In addition, the SEC is proposing related amendments to: (1) Rule 12d1-1 to 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, and (2) Form N-CEN to require funds that rely on the Proposed Rule to include information regarding their reliance on the Proposed Rule on their Form N-CENs.

The Proposed Rule contains several potentially very controversial requirements.

Comments on the Proposed Rule must be received by the SEC 90 days after publication in the Federal Register. [2]

II. BACKGROUND AND CURRENT FRAMEWORK OF SECTION 12(D)(1)

Section 12(d)(1)(A) prohibits registered funds from owning more than 3% of another registered fund's outstanding voting securities, investing more than 5% of the fund's total assets in another registered fund, and investing more than 10% of the fund's total assets in other registered funds in the aggregate. Section 12(d)(1)(B) places parallel prohibitions on the sales of shares by acquired funds. These restrictions were enacted to prevent "pyramiding," excessive fees, and the formation of overly complex structures.

Since the enactment of Section 12(d)(1)(A), funds increasingly invest in other funds as a way to achieve asset allocation, diversification or other investment objectives. [3] As a result of evolving views on fund of funds arrangements, Congress created statutory exceptions that permitted different types of fund of funds arrangements subject to certain conditions, and the SEC has provided exemptive relief under many conditions for fund of funds arrangements. This combination of statutory exemptions, rules, and exemptive orders has created a regulatory regime where substantially similar fund of funds arrangements may be subject to different conditions. The SEC stated that it seeks to address these inconsistencies by rescinding Rule 12d1-2 and many of the exemptive orders granting relief from the restrictions of Section 12(d)(1) and adopting in their place the Proposed Rule.

III. THE PROPOSED RULE

The Proposed Rule would allow any registered investment company (exchange-traded fund ("ETF"), open-end fund, or closed-end fund) or business development company ("BDC") (referred to as "acquiring funds") to acquire securities of any other registered investment company (ETF, open-end fund, or closed-end fund) or BDC (referred to as "acquired funds") in excess of the limits imposed by Section 12(d)(1), subject to certain conditions. [4] Proposed Rule 12d1-4 also provides exemptive relief from Section 17(a), which generally prohibits an affiliated person of a fund from selling any security or other property to, or purchasing any security or other property from, the fund. Absent exemptive relief, Section 17(a) could prohibit a fund that holds 5% or more of the acquired fund's securities from making additional investments in the acquired fund.

The Proposed Rule would streamline the regulatory framework by imposing universal conditions on fund of funds arrangements. The conditions are based on certain conditions in certain exemptive orders that the SEC has issued permitting fund of funds arrangements. The conditions imposed on these fund of funds arrangements are still focused on preventing the abusive practices behind the rationale for Section 12(d)(1). [5]

a. Control and Voting

The Proposed Rule would prohibit an acquiring fund and its advisory group from controlling, individually or in the aggregate, an acquired fund, except in certain circumstances. The 1940 Act creates a rebuttable presumption that any person who directly or indirectly beneficially owns more than 25% of the voting securities of a company controls the company and that one who does not own that amount does not control the company. [6] Accordingly, an acquiring fund as aggregated with its entire advisory group's beneficial ownership (for example, through affiliated funds' ownership) of up to 25% of the voting securities of an acquired fund would be presumed not to constitute control over the acquired fund.

The Proposed Rule would require an acquiring fund (with important exceptions noted below) that holds more than 3% of an acquired fund's outstanding voting securities to vote those securities in a manner prescribed by the Proposed Rule. Specifically, in these circumstances, the acquiring fund would be required to either: (1) seek voting instructions from its security holders and vote such proxies in accordance with their instructions (pass-through voting), or (2) vote the shares held by it in the same proportion as the vote of all other holders of the acquired fund (mirror voting).

The Proposed Rule would include exceptions to the control (more than 25% ownership) and voting conditions when: (1) an acquiring fund is within the same group of investment companies as an acquired fund, or (2) 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. The SEC further

proposed to define the term “group of investment companies” as “any two or more registered investment companies or business development companies that hold themselves out to investors as related companies for investment and investor services.” [7] These exceptions are designed to include arrangements that are permissible under Section 12(d)(1)(G) and current exemptive orders and would not require affiliated fund of funds to limit voting.

b. Redemptions

To address concerns that an acquiring fund could threaten large-scale redemptions as a means of exercising undue influence over an acquired fund, the Proposed Rule would prohibit an acquiring fund that acquires more than 3% of an acquired fund's outstanding shares (i.e., the statutory limit imposed by Section 12(d)(1)(A)(i)) from redeeming or submitting for redemption, or tendering for repurchase, more than 3% of an acquired fund's total outstanding shares in any 30-day period.

Perhaps surprisingly, to the extent that an affiliated fund of funds that also invests in unaffiliated funds and/or directly in securities must rely on the Proposed Rule, such a fund would now be restricted in its ability to redeem affiliated funds (those within the same fund group). This would be a very significant change from current practice, where affiliated fund of funds may own and freely redeem significant amounts of affiliated underlying funds. This proposal also could, in practical effect, limit the realistic ability of an acquiring fund to invest in another fund if the acquiring fund is open ended and would need to treat its now redemption-restricted investment as illiquid. This limitation could even result in avoidance of the Proposed Rule as a practical matter.

c. Duplicative and Excessive Fees

These conditions are designed to prevent duplicative and excessive fees in fund of funds arrangements, a key concern underlying the enactment of Section 12(d)(1). The conditions vary based on the structural characteristics of the acquiring fund but generally hinge on a determination that the arrangement's aggregate fees do not implicate the historical abuses that Section 12(d)(1) was intended to prevent.

Management Companies. In cases where the acquiring fund is a management company, the Proposed Rule would require the acquiring fund's adviser to determine that it is in the best interest of the acquiring fund to invest in the acquired fund. The Proposed Rule would require the adviser to make this determination before investing in acquired funds in reliance on the rule, and thereafter with such frequency as the board of directors of the acquiring fund, by resolution, deems reasonable and appropriate, but in any case, no less frequently than annually. The Proposed Rule also would require the adviser to report its finding and the basis for the finding to the board. The Proposed Rule would require the acquiring fund's investment adviser to evaluate specifically: (1) the complexity of the fund of funds structure, and (2) the aggregate fees associated with the fund's investment in an acquired fund. While the Proposed Rule does not require board findings, the SEC states in its release that an acquiring fund board must review the adviser's findings, thus in practice requiring additional board responsibilities. However, the Proposed Rule eliminates current exemptive order conditions that impose on acquiring fund boards various other requirements.

Unit Investment Trusts. The Proposed Rule sets forth an alternative fee condition when the acquiring fund in a fund of funds arrangement is a UIT. Specifically, on or before the date of initial deposit of portfolio securities into a registered UIT, the UIT's principal underwriter or depositor must evaluate the complexity of the structure and the aggregate fees associated with the UIT's investment in acquired funds and find that the fees of the UIT do not duplicate the fees of the acquired funds that the UIT holds or will hold at the date of deposit.

Separate Accounts Funding Variable Insurance Contracts. With respect to a separate account funding variable insurance contracts that invests in an acquiring fund, the Proposed Rule would require an acquiring fund to obtain a certification from the insurance company issuing the separate account that it has determined that the fees 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. This standard provides that the fees must be reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurance company.

Recordkeeping Requirements. The Proposed Rule requires the adviser's findings, which were discussed above, to be maintained as fund records.

d. Complex Structures

The Proposed Rule contains conditions designed to restrict fund of funds arrangements to two tiers (other than in limited circumstances). Specifically, the Proposed Rule would include a condition designed to prevent an acquiring fund from also being an acquired fund under the Proposed Rule or under Section 12(d)(1)(G) of the 1940 Act. To facilitate this, the Proposed Rule would require a fund that relies on the Proposed Rule (or wants to preserve investment flexibility to rely on the Proposed Rule) to disclose in its registration statement that it is (or may be) an acquiring fund for purposes of the Proposed Rule. This disclosure would allow a fund to limit its acquisition of the acquiring fund's securities accordingly.

In addition, the Proposed Rule would include a condition designed to limit fund of funds arrangements where the acquired fund is itself an acquiring fund. Specifically, the Proposed Rule generally would prohibit arrangements where an acquired fund invests in other investment companies in excess of the limits in Section 12(d)(1)(A) or in private funds.

The Proposed Rule would contain certain exceptions to these prohibitions that would permit arrangements where: (1) an acquired fund invests in another fund beyond the statutory limits for short-term cash management purposes or in connection with interfund lending or borrowing transactions, (2) an acquired fund invests all of its assets in a master fund or invests in a wholly owned subsidiary, and (3) an acquired fund receives fund shares as a dividend or as a result of a plan of reorganization.

IV. PROPOSED RESCISSION OF RULE 12D1-2 AND CERTAIN EXEMPTIVE RELIEF AND PROPOSED AMENDMENTS TO RULE 12D1-1

In addition, the SEC is proposing to rescind Rule 12d1-2, which permits funds that invest in funds within the same fund group to invest in unaffiliated funds and also direct investments in nonfund assets. The SEC also is proposing to rescind the SEC's very numerous exemptive orders permitting fund of funds arrangements, with limited exceptions. As a result of rescinding Rule 12d1-2 and certain exemptive relief, funds wishing to create certain types of fund of funds arrangements that exceed the statutory limitations would be required to rely on the Proposed Rule and comply with its associated conditions. This requirement would significantly alter current fund of funds practices, including, for example, forcing a fund that also invests directly in securities to rely on the Proposed Rule, with its accompanying redemption restrictions, or abandon its direct investments. The Proposed Rule allows a one-year transition period in recognition that many funds would need to alter their current practices.

In addition, the SEC is proposing an amendment to Rule 12d1-1 to provide funds relying on Section 12(d)(1)(G) with continued flexibility to invest in money market funds outside of the same group of investment companies if

they rely on Section 12(d)(1)(G). The SEC believes that retaining this flexibility will help to ensure that funds in smaller complexes that do not have a money market fund as part of their fund complex may invest available cash in an unaffiliated money market fund. [8] This addition would be needed because a "pure" affiliated fund of funds could no longer rely on Rule 12d1-2 (which would be rescinded) to invest in anything other than affiliated funds unless it wholly adopted reliance on the Proposed Rule.

V. AMENDMENTS TO FORM N-CEN

Finally, the SEC is also proposing to add a requirement to Form N-CEN that would obligate management companies to report if they relied on the Proposed Rule or the statutory exception in Section 12(d)(1)(G) during the reporting period. The SEC is proposing to collect this information in order to better assess reliance on the Proposed Rule or the statutory exception.

NOTES

[1] Fund of Funds Arrangements, SEC Release Nos. 33-10590 & IC-33329, p. 6 (Dec. 19, 2018) (the "*SEC Release*").

[2] As of the date of this Alert, the SEC Release has not been published in the Federal Register.

[3] *SEC Release*, at 7.

[4] The Proposed Rule expands both the scope of permissible types of acquiring funds and permissible types of acquired funds to generally expand the scope of fund of funds arrangements. For example, the Proposed Rule would increase permissible investments for closed-end funds beyond ETFs to allow them to invest in open-end funds, unit investment trusts (each, a "UIT"), other closed-end funds, and BDCs in excess of the limits of Section 12(d)(1). However, "private funds" relying on Section 3(c)(1) or 3(c)(7) and unregistered investment companies (foreign funds such as, for example, Undertakings for Collective Investment in Transferable Securities) are excluded from the scope of the Proposed Rule because these types of funds are not registered with the SEC and would not be subject to the reporting requirements that the SEC is proposing on Form N-CEN regarding reliance on the Proposed Rule.

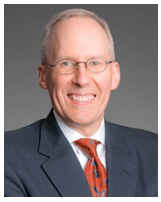
[5] It should be noted that a fund that has control over an investment company (either by acquiring more than 25% of the investment company's voting securities or through other facts and circumstances) cannot rely on proposed Rule 12d1-4 with an important exception for funds within the same complex.

[6] In assessing control, an acquiring fund's investment in an acquired fund would be aggregated with the investment of the acquiring fund's advisory group. The Proposed Rule would not require an acquiring fund to aggregate the ownership of an acquiring fund advisory group with an acquiring fund subadvisory group.

[7] *SEC Release*, at 39.

[8] *SEC Release*, at 92.

KEY CONTACTS



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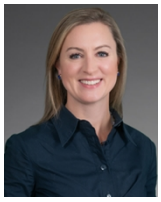

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