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SEC Proposes Rule and Rule Amendments For Fund of Funds

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At an open meeting on December 19, 2018, the Securities and Exchange Commission (SEC) proposed a new rule and rule amendments to streamline and enhance the regulatory requirements for registered investment companies and business development companies (together, Funds) to acquire shares of other Funds (Fund of Funds Arrangements), in excess of the limits in Section 12(d)(1) of the Investment Company Act of 1940 (1940 Act). Currently, Fund of Funds Arrangements are permitted through statutory exemptions in the 1940 Act, SEC rules under the 1940 Act and SEC exemptive orders. The SEC is proposing the following:

- New Rule 12d1-4 under the 1940 Act;
- Rescission of Rule 12d1-2 under the 1940 Act;
- Rescission of most SEC orders granting exemptions from 12(d)(1)(A), (B), (C) and (G) of the 1940 Act;
- Amendments to Rule 12d1-1 under the 1940 Act; and
- Amendments to Form N-CEN.

These proposals are described below.

Proposed Rule 12d1-4

Proposed Rule 12d1-4 would allow Funds (“Acquiring Funds”) subject to certain conditions to acquire shares of other Funds (“Acquired Funds”) without obtaining a Fund of Funds exemptive order from the SEC. The proposed rule builds upon the Fund of Funds exemptive orders that have historically been issued by the SEC and permit additional types of Fund of Fund Arrangements. Exchange-traded managed funds (ETMFs), listed and unlisted closed-end funds and listed and unlisted business development companies would be Acquiring and Acquired Funds within the scope of the proposed rule. Also, mutual funds, exchange traded funds and other Funds would be able to acquire shares of unlisted closed-end funds, such as interval funds, and unlisted business development companies beyond the Section 12(d)(1) limits. Private funds and unregistered investment companies, such as foreign investment companies, are not within the scope of the proposed rule.

The proposed rule also subjects Fund of Funds Arrangements to a tailored set of conditions designed to address the historical abuses associated with Fund of Funds Arrangements. Again, these conditions are based on the conditions contained in SEC exemptive orders with some differences as shown in the chart below.

	Existing Fund of Funds Exemptive Relief	Proposed Rule 12d1-4
Control and Voting	<p>Differing voting conditions and procedures to prevent undue influence.</p> <p>Fund of Fund participation agreements/Board procedures and findings to prevent undue influence</p>	<p>If an Acquiring Fund and its advisory group in the aggregate hold more than 3 percent of an Acquired Fund’s outstanding voting securities must use pass-through or mirror voting to minimize the influence that an Acquiring Fund may exercise over an Acquired Fund. An Acquiring Fund that is part of the same fund group as the Acquired Fund and an Acquiring Fund that has a sub-adviser that acts as adviser to the Acquired Fund would not be subject to the control and voting conditions.</p> <p>Redemption restrictions (described below) replace the requirements for certain Board procedures and findings and Fund of Funds participation agreements.</p>

	Existing Fund of Funds Exemptive Relief	Proposed Rule 12d1-4
Redemption Limits	No general requirement for ETFs that are Acquired Funds and varying exemptive relief for other types of Acquired Funds	Prohibits an Acquiring Fund that acquires more than 3 percent of an Acquired Fund's outstanding shares from redeeming more than 3 percent of the Acquired Fund's total outstanding shares in any 30-day period. This prohibition addresses concerns that an Acquiring Fund could threaten large-scale redemptions to exert undue influence over an Acquired Fund.
Duplicative or Excessive Fees	Requires investment adviser to Acquiring Fund to waive advisory fees in certain circumstances or the Board of the Acquiring Fund must make certain findings regarding the advisory fees (e.g., not duplicative). Limits on sales charges and service fees.	Advisers to management companies would be required to evaluate the complexity of the Fund of Funds Arrangement and the associated aggregate fees associated with investment in the Acquired Fund and determine that it is in the best interest of the Acquiring Fund to invest in the Acquired Fund. The adviser would be required to report such determination and the basis for the determination to the Board of the Acquiring Fund before investing and at least annually. This evaluation would not be required for each individual investment. Section 15 of the 1940 Act requires the Board of the Acquiring Fund to evaluate any information reasonably necessary to evaluate the terms of the Acquiring Fund's advisory contract (including fees for services provided by the Acquiring Fund's adviser). Proposed rule does not require that the Board of the Acquiring Fund find that the advisory fees are based on services provided that are in addition to, rather than duplicative of, services provided by the Acquired Fund's adviser and do not require an Acquiring Fund's adviser to waive fees received from an Acquired Fund. No sales charge or service fees limits because certain Fund of Funds Arrangement are otherwise subject to limits by the Financial Industry Regulatory Authority (FINRA) Rule 2341.
Complex Structures	Limits ability of Acquired Fund to invest in underlying funds (three-tier Fund of Funds Arrangements)	Prohibits a fund relying on Section 12(d)(1)(G) or Proposed Rule 12d1-4 from investing in an Acquiring Fund and limits Acquired Funds from investing in underlying funds (three-tier structures). Requires an evaluation of the complexity of the Fund of Funds structure. (e.g., comparison to direct investment in similar assets held by an Acquired Fund). (see above) An Acquiring Fund will be required to disclose that it is or may at times be an Acquiring Fund in its registration statement.

Proposed Rescission of Rule 12d1-2 and SEC Fund of Funds Exemptive Orders and Proposed Amendments to Rule 12d1-1 and Form N-CEN

Rule 12d1-2 permits a Fund that is relying Section 12(d)(1)(G) of the 1940 Act to acquire securities of Funds within the same group of investment companies to also invest in securities of other Funds that are not part of the same group of investment companies and other types of securities. In coordination with Proposed Rule 12d1-4, the SEC is proposing to rescind rule 12d1-2 and exemptive orders permitting Fund of Funds Arrangements, with limited exceptions. Also, the SEC is proposing to rescind the exemptive orders contained in SEC ETF and ETMF exemptive orders. The SEC does not propose to rescind exemptive orders permitting interfund lending arrangements. Funds currently relying on Rule 12d1-2 and existing exemptive orders would be required to rely on Proposed Rule 12d1-4 and comply with its associated conditions. The SEC has proposed a one-year grace period after the effective date of the Proposed Rule 12d1-4 to rescind Rule 12d1-2 and existing exemptive orders to minimize the impact on certain existing Fund of Funds Arrangements.

The SEC is also proposing amending Rule 12d1-1 to allow Funds relying on Section 12(d)(1)(G) to continue investing in an unlimited amount of unaffiliated money market funds (e.g., cash sweep arrangements). It also has proposed amendments to Form N-CEN to require Funds to report whether they relied on rule 12d1-4 or Section 12(d)(1)(G) during the applicable reporting period.

Additionally, the Division of Investment Management is reviewing no-action letters under Section 12(d)(1) to determine whether certain no-action letters should be withdrawn.

Comment Period

The SEC has requested comments on the rule proposals. The comment period for Proposed Rule 12d1-4 will end 90 days after publication in the Federal Register. Although the SEC commissioners at the open meeting emphasized their concerns regarding the scope of the Proposed Rule 12d1-4, the SEC voted unanimously to propose the new rule and related proposals. Specifically, SEC Commissioner Kara M. Stein said that the scope of the proposed rule extended too broadly, while Commissioner Hester M. Peirce expressed interest in potentially expanding the proposed rule to cover private funds and unregistered investment companies.

Practice Points and Tips

The elimination of the need for Acquiring Funds to obtain individual SEC exemptive relief would create cost efficiencies and reduce delays in the Fund of Funds Arrangements process. Further, Proposed Rule 12d1-4 would tailor the conditions and provide additional flexibility for Fund of Funds Arrangements.

Advisers and Boards to existing Fund of Funds should consider the impact of the proposals, if adopted, on the Funds that they manage and oversee and any required policies and procedures.

Investment Management Team

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