SEC Updates Regulatory Framework for Fund of Funds Arrangements

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SEC Adopts Rule Changes for Fund of Funds Arrangements

In an October 7, 2020 release (the "**Adopting Release**"), the Securities and Exchange Commission (the "**SEC**") adopted new rule 12d1-4 (the "**Final Rule**") under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), to "streamline and enhance the regulatory framework applicable to funds that invest in other funds" (otherwise known as "fund of funds" arrangements). In connection with the Final Rule, the SEC: (i) adopted related amendments to Rule 12d1-1 under the Investment Company Act and to Form N-CEN; and (ii) rescinded Rule 12d1-2 under the Investment Company Act and most exemptive orders granting relief from sections 12(d)(1)(A), (B), (C), and (G) of the Investment Company Act.

The Final Rule was adopted in largely the same form as the rule proposed in December 2018 (the "**Proposed Rule**") with "several modifications designed to increase the workability of the rule's requirements, while enhancing protections for investors in fund of fund arrangements." The Adopting Release states that the Final Rule will be effective 60 days after publication in the Federal Register but "in order to facilitate a transition period", the compliance date for the amendments to Form N-CEN will be 425 days after publication in the Federal Register and Rule 12d1-2 and the SEC's exemptive orders will be rescinded one year from the effective date of the Final Rule.

The Final Rule, under certain specified conditions, "will allow a fund to acquire the shares of another fund in excess of the limits of the Investment Company Act without obtaining an individual exemptive order from the [SEC] if the funds comply with conditions designed to enhance consumer protection." According to the Adopting Release, "Main Street" investors are increasingly using mutual funds, ETFs and other types of funds for asset allocation, diversification, or other investment objectives. The new framework will "enhance and modernize the regulatory framework for these arrangements."

According to the Adopting Release, the Final Rule "reflects decades of experience" with fund of funds and will protect investors by requiring funds relying on the Final Rule to follow conditions "tailored to enhance investor protections while providing funds the flexibility to meet their investment objectives in a consistent matter." The Adopting Release notes that the rescission of Rule 12d1-2 under the Investment Company Act and individual exemptive orders for certain fund of funds arrangements will "create a consistent and efficient rules-based regime for the formation and

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oversight of funds of funds." Lastly, in connection with the rescission of Rule 12d1-2, the SEC also amended Rule 12d1-1 under the Investment Company Act to "allow funds that rely on section 12(d)(1)(G) of the Investment Company Act to invest in money market funds that are not part of the same group of investment companies."

Overview of Section 12(d)(1) Limits

The Adopting Release notes that section 12(d)(1) of the Investment Company Act was enacted to guard against abuses historically related to control by acquiring fund shareholders, including "pyramiding," which is a practice under which "investors in the acquiring fund could control the assets of the acquired fund and use those assets to enrich themselves at the expense of the acquired fund shareholders by virtue of their stake in the acquired fund." According to the Adopting Release, Congress was also concerned with the "potential for duplicative and excessive fees when one fund invested in another, and the formation of overly complex structures that could be confusing to investors."

Under section 12(d)(1)(A) of the Investment Company Act generally, a registered fund (and companies or funds it controls) cannot: (i) acquire more than 3% of another registered fund's outstanding voting securities; (ii) invest more than 5% of its total assets in any one registered fund; or (iii) invest more than 10% of its total assets in registered funds generally. In addition, under section 12(d)(1)(A), neither a private fund nor a foreign fund generally can acquire more than 3% of a registered fund's outstanding voting securities. Under section 12(d)(1)(B) generally, a registered open-end fund cannot knowingly sell "securities to any other investment company [including private funds for purposes of clause (i)] if, after the sale, the acquiring fund would: (i) together with companies it controls, own more than 3% of the acquired fund's outstanding voting securities; or (ii) together with other funds (and companies they control), own more than 10% of the acquired fund's outstanding voting securities." Under section 12(d)(1)(C) generally, it is unlawful "for 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." According to the Adopting Release, in order to avoid overregulation of legitimate fund of funds arrangements, Congress enacted exceptions for three types of fund of funds arrangements: (i) conduit or master-feeder arrangements (section 12(d)(1)(E)), (ii) unaffiliated fund of funds arrangements (section 12(d)(1)(F)), and affiliated fund of funds arrangements (section 12(d)(1)(G)). Congress also empowered the SEC to provide exemptions for additional types of fund of funds arrangements, which the SEC exercised in 2006, when it adopted Rules 12d1-1, 12d1-2 and 12d1-3. The Adopting Release also notes that the SEC has issued numerous exemptive orders permitting fund of funds arrangements.

According to the Adopting Release, the combination of existing statutory

exemptions, SEC rules and exemptive orders has created a “regulatory regime where substantially similar fund of funds arrangements are subject to different conditions.” Thus, in order to create a “more consistent and efficient regulatory framework for fund of funds arrangements,” the SEC has proposed to rescind Rule 12d1-2 and a majority of the exemptive orders that grant relief from sections 12(d)(1)(A), (B), (C), and (G) of the Investment Company Act. The Adopting Release notes that the SEC is replacing that relief with a comprehensive fund of funds framework under new Rule 12d1-4 and to “reduce confusion and subject similar fund of funds arrangements to tailored conditions that will enhance investor protection, while continuing to provide funds with investment flexibility to meet their investment objectives.”

Scope of Rule 12d1-4 and Exemptions from Section 12(d)(1) of the Investment Company Act

*Registered Funds and Business Development Companies ("**BDCs**"):* According to the Adopting Release, the Final Rule allows a registered investment company or BDC (collectively, "**Acquiring Funds**") to acquire the securities of any other registered investment company or BDC (collectively, "**Acquired Funds**") in excess of the limits described above, subject to conditions "that are designed to address historical abuses associated with fund of funds arrangements." The Adopting Release notes that registered open-end funds, unit investment trusts ("**UITs**"), closed-end funds (including BDCs), exchange-traded funds ("**ETFs**"), and exchange-traded managed funds ("**ETMFs**") can rely on the Final Rule as both Acquiring Funds and Acquired Funds.

In addition to fund of funds arrangements that are currently permitted under SEC exemptive orders, the Final Rule will:

- Allow open-end funds, UITs and ETFs to invest in unlisted closed-end funds and unlisted BDCs beyond the limits in section 12(d)(1);
- Increase permissible investments for closed-end funds beyond ETFs and ETMFs to allow them to invest in open-end funds, UITs, other closed-end funds, and BDCs beyond the limits in section 12(d)(1);
- Allow BDCs to invest in open-end funds, UITs, closed-end funds, other BDCs and ETMFs; and
- Allow ETMFs to invest in all registered funds and BDCs.

While several commenters supported including all open-end funds, UITs, BDCS and other close-ended funds within the scope, one commenter questioned whether one rule should apply to all types of fund of fund arraignments. According to the Adopting Release, the SEC adopted the Final Rule, which consistent with the Proposed Rule, does not turn on the type of fund in the arrangement, but rather "address[es] the 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."

According to the Adopting Release, the SEC believes the Final Rule will

protect fund investors at both tiers of a fund of funds arrangement while also: (i) providing the "appropriate flexibility for innovative fund of funds structures" (ii) eliminating "unnecessary and potentially confusing distinctions among permissible investments for different types of [A]cquiring [F]unds"; and (iii) leveling "the playing field among these entities."

Private Funds and Unregistered Investment Companies: According to the Adopting Release, private funds and unregistered investment companies are not within the Final Rule's scope of Acquiring Funds, and as a result, private funds and unregistered investment companies may acquire no more than 3% of a U.S. registered fund under the Investment Company Act, absent a separate exemption. Several commenters suggested that the SEC broaden the scope of the Final Rule to include investments by private funds or unregistered investment companies for many of the same reasons the SEC adopted the rule for registered funds, such as efficient allocation, diversification and hedging purposes, as such supporters noted that "such funds do not operate in a materially different manner from registered funds and therefore the concerns underlying section 12(d)(1) are not any more pronounced for private and unregistered investment companies…." Other commentators also suggested additional conditions that could apply to private funds and unregistered investment companies.

After considering the comments, the SEC determined not to include private funds and unregistered investment companies as Acquiring Funds under the Final Rule because the SEC believes it would be "more appropriate to consider designing protective conditions" through the individualized exemptive application process in order to address the different concerns and "allow the [SEC] to weigh the policy considerations" based on the specific circumstances of the specific arrangement. The Adopting Release notes that since private funds and unregistered investment companies are not registered with the SEC and not subject to certain governance and compliance requirements designed to "protect investors and reduce conflicts of interest that are inherent in a fund structure," the SEC would be unable to ensure that integral oversight and monitoring provisions of the Final Rule would be complied with. Specifically, private funds and unregistered investment companies are not subject to (i) board governance requirements under the Investment Company Act, (ii) chief compliance officer requirements under rule 38a-1, and (iii) the reporting requirements that the SEC adopted on Form N-CEN regarding reliance on the Final Rule. Further, private funds and unregistered investment funds would not report information regarding their Acquired Fund holdings on Form N-PORT and are not subject to the recordkeeping requirements under the Investment Company Act. According to the Adopting Release, these requirements are integral to the provisions of the Final Rule and designed to "protect investors and reduce conflicts of interest that are inherent in a fund structure."

In addition to the challenges applicable to unregistered funds described above, foreign funds create additional challenges. According to the Adopting Release, some foreign laws and regulations may limit or prevent disclosure to the SEC. Additionally, the Adopting Release notes that the risk of abusive practices with foreign unregistered investment companies were of concern to Congress in drafting the amendments to Section

12(d)(1) in 1970.

Conditions of Final Rule

According to the Adopting Release, the conditions of the Proposed Rule are designed "to prevent the abuses that historically were associated with fund of funds arrangements," and are based on the conditions contained in exemptive orders granted by the SEC as well as from commenters' suggestions.

Advisory Group

The Final Rule defines "advisory group" to mean "either: (1) an [A]cquiring [F]und's investment adviser or depositor, and any person controlling, controlled by, or under common control with such investment adviser or depositor; or (2) an [A]cquiring [F]und's investment sub-adviser and any person controlling, controlled by, or under common control with such investment sub-adviser."

Control

The applicable condition in the Final Rule requires that "[t]he [A]cquiring [F]und and its advisory group [. . .] not control (individually or in the aggregate) an [A]cquired [F]und." The Investment Company Act defines control 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 such company." Further, the Investment Company 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 it." It should also be noted that such "[a] determination of control depends on the facts and circumstances of the particular situation."

The below table sets forth a general overview of the differences between the conditions under current exemptive relief, the Proposed Rule and the Final Rule:

	Condition Under Existing Exemptive Orders	**Condition Under the Proposed Rule**	**Condition Under the Final Rule**
Control/ Voting	Voting conditions (including the point at which the voting conditions is triggered) differ based on the type of Acquired Fund.	In order to prevent a fund from exerting undue influence over another fund, the Proposed Rule would have prohibited an Acquiring Fund and its advisory group from controlling, individually or in the aggregate, an Acquired Fund, except in the circumstances discussed below. The voting conditions did not differ based on the type of Acquired Fund. Instead, under the Proposed Rule, all Acquiring Funds that do not fall within the control exception discussed below were subjected to the same voting condition: an Acquiring Fund and its advisory group must use pass-through (seek voting instructions from security holders and vote such proxies in accordance with their instructions) or mirror voting (vote the shares held by it in the same proportion as the vote of all other	In order to prevent a fund from exerting undue influence over another fund, the Final Rule prohibits an Acquiring Fund and its advisory group from controlling, individually or in the aggregate, an Acquired Fund, except in the circumstances discussed below. The voting conditions (including the point at which the voting conditions is triggered) differ based on the type of Acquired Fund. The voting conditions require an Acquiring Fund and its advisory group to use mirror voting when they hold more than: (i) 25% of the outstanding voting securities of an open-end fund or UIT due to a decrease in

	Condition Under Existing Exemptive Orders	Condition Under the Proposed Rule	Condition Under the Final Rule
		holders of the Acquired Fund) when they hold more than 3% of the Acquired Fund's outstanding voting securities. The Proposed Rule included exceptions to this condition where: (i) an Acquiring Fund is within the same group of investment companies as an Acquired Fund; or (ii) the Acquiring Fund's investment sub-adviser or any person controlling, controlled by, or under common control with such investment sub-adviser acts as the Acquired Fund's investment adviser or depositor.	the outstanding securities of the acquired fund; or (ii) 10% of the outstanding voting securities of a closed-end fund. In circumstances where Acquiring Funds are the only shareholders of an Acquired Fund, however, pass-through voting may be used. The Final Rule includes exceptions to this condition where: (i) an Acquiring Fund is within the same group of investment companies as an Acquired Fund; or (ii) the Acquiring Fund's investment sub-adviser or any person controlling, controlled by, or under common control with such investment sub-adviser acts as the Acquired Fund's investment adviser or depositor.

Investment Agreement

In response to comments on the Proposed Rule, the SEC decided to eliminate the proposed 3% redemption limit and follow an approach similar to that used in the exemptive orders, which requires an investment agreement and expanded fund findings. This provides funds with the ability to tailor their protections to better promote against potential undue influence.

	Condition Under Existing Exemptive Orders	Condition Under the Proposed Rule	Condition Under the Final Rule
Redemptions/Investment Agreement	Fund boards must make certain findings and adopt procedures in order to prevent overreaching and undue influence by the Acquiring Fund and its affiliates. Existing exemptive relief requires a participation agreement between the Acquiring Fund and the Acquired Fund under which the parties are required to fulfill their responsibilities under.	To address concerns that an Acquiring Fund "could threaten large-scale redemptions as a means of exercising undue influence over an [A]cquired [F]und," the Proposed Rule prohibited an Acquiring Fund that acquires more than 3% of an Acquired Fund's outstanding shares from redeeming or submitting for redemption, or tendering for repurchase, more than 3% of the Acquired Fund's total outstanding shares in any 30-day period.	The SEC determined to eliminate the 3% redemption limit contained in the Proposed Rule. The Final Rule requires a fund of funds investment agreement between an Acquiring Fund and an Acquired Fund, which must include: (i) any material terms necessary for each adviser to make the appropriate findings under the Final Rule; (ii) a termination provision whereby either party can terminate the agreement with advance written notice within a period no longer than 60 days; and (iii) a provision requiring an acquired fund to provide the acquiring fund with fee and expense information to the extent reasonably requested. The Final Rule does not require Acquired Funds and Acquiring Funds that are advised by the same primary investment adviser to enter into an investment agreement.

Excessive & Duplicative Fees

The Adopting Release notes that, "In evaluating the complexity of a fund of funds structure, an adviser to an Acquiring Fund should consider the complexity of an [A]cquiring [F]und's investment in an [A]cquired [F]und versus direct investment in assets similar to the [A]cquired [F]und's holdings. The adviser should consider whether the resulting structure would make it difficult for shareholders to appreciate the fund's exposures and risks. The adviser should consider whether an investment in an [A]cquired [F]und would circumvent the [A]cquiring [F]und's investment restrictions and limitations."

The Adopting Release notes that, "[A]n adviser should consider whether the [A]cquired [F]und's advisory fees are for services that are in addition to, rather than duplicative of, the adviser's services to the [A]cquiring [F]und. The adviser should consider sales charges and other fees, including fees for recordkeeping, sub-transfer agency services, sub-accounting services, or other administrative services."

Advisers to Acquired Funds will be required to consider a specific list of non-exhaustive factors to "help ensured that acquired fund advisers make appropriate determinations when assessing whether a fund of funds arrangement has terms that reasonably address undue influence by the [A]cquiring [F]und."

	Condition Under Existing Exemptive Orders	Condition Under the Proposed Rule	Condition Under the Final Rule
Excessive & Duplicative Fees/Fund Findings	In certain circumstances the existing exemptive relief: (i) requires an adviser to an Acquiring Fund to waive its advisory fees; or (ii) requires the board of the Acquiring Fund to find that the fees are not duplicative.	Where the Acquiring Fund is a management company, the Acquiring Fund's adviser must determine that it is in the best interest of the Acquiring Fund to invest in the Acquired Fund by evaluating: (i) the complexity of the fund of funds structure; and (ii) the aggregate fees associated with the investment. The adviser must make this determination before investing in the Acquired Fund, "and thereafter with such frequency as the board of directors of the [A]cquiring [F]und…deems reasonable and appropriate but in any case, no less frequently than annually." The Proposed Rule also required the adviser to report its findings to the board of the Acquiring Fund at the same frequency as the analysis. The Proposed Rule also included recordkeeping requirements related to this determination. According to the Proposing Release, the adviser need not make these evaluations "in connection with every investment in an [A]cquired [F]und." For example, "an adviser to a fund that invests regularly in	The Final Rule requires that where the Acquiring Fund is a management company, the Acquiring Fund's adviser must evaluate the complexity of the fund of funds structure and the fees and expenses associated with the investment, and determine that the acquiring fund's fees and expenses do not duplicate the fees and expenses of the acquired fund. Advisers to Acquired Funds that are management companies will be required to consider a specific list of non-exhaustive factors to "help ensure that [A]cquired [F]und advisers make appropriate determinations when assessing whether a fund of funds arrangement has terms that reasonably address undue influence by the [A]cquiring [F]und." These factors include: (i) the scale of contemplated investments by the Acquiring Fund and any maximum

	Condition Under Existing Exemptive Orders	Condition Under the Proposed Rule	Condition Under the Final Rule
		[A]cquired [F]unds as part of its strategy could consider establishing parameters for routine investments in [A]cquired [F]unds and review individual transactions that are outside of those parameters."	investment limits; (ii) the anticipated timing of redemption requests by the Acquiring Fund; (iii) whether, and under what circumstances, the Acquiring Fund will provide advance notification of investment and redemptions; and (iv) 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.
		Section 15 of the Investment Company Act already requires the board to evaluate any information reasonably necessary to evaluate the terms of an Acquiring Fund's advisory contracts (including the fees for services provided by the adviser). The Proposed Rule did not require the board to find that advisory fees are based on services that are in addition to, rather than duplicative of, services provided by the Acquired Fund's adviser and also did not require an Acquiring Fund's adviser to waive fees received from	Section 15 of the Investment Company Act already requires the board of an Acquiring Fund to evaluate any information reasonably necessary to evaluate the terms of an Acquiring Fund's advisory contracts (including the fees for services provided by the adviser). The Final Rule does not require the board to find that advisory fees are based on services that are in addition to, rather than duplicative of, services provided by the

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	Condition Under Existing Exemptive Orders	Condition Under the Proposed Rule	Condition Under the Final Rule
		an Acquired Fund (as has been required in prior exemptive orders).	Acquired Fund's adviser and also does not require an Acquiring Fund's adviser to waive fees received from an Acquired Fund (as has been required in prior exemptive orders). Rather, the Final Rule requires that the Acquiring Fund's adviser find that aggregate fees and expenses are not duplicative and report this finding to the Fund's board of directors. The Final Rule requires the adviser to report its evaluations, findings and the basis for its evaluations or findings to the board of directors, no later than the next regularly scheduled board meeting.
		The Proposed Rule also set forth an alternative fee condition in the case of an Acquiring Fund that is a UIT. The Proposing Release noted that "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	The Final Rule also sets forth an alternative finding condition when the Acquiring Fund is a UIT. The Adopting Release notes that "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

	Condition Under Existing Exemptive Orders	Condition Under the Proposed Rule	Condition Under the Final Rule
		UIT's investment in [A]cquired [F]unds, and find that the fees of the UIT do not duplicate the fees of the [A]cquired [F]unds that the UIT holds or will hold at the date of deposit."	structure and the aggregate fees associated with the UIT's investment in [A]cquired [F]unds, and find that the fees of the UIT do not duplicate the fees of the [A]cquired [F]unds that the UIT holds or will hold at the date of deposit." The Final Rule requires "the principal underwriter or depositor to base its finding on an evaluation of the complexity of the structure and the aggregate fees and expenses associated with the UIT's investment in [A]cquired [F]unds."
		Finally, with respect to separate accounts that fund variable insurance contracts that invest in an Acquiring Fund, the Proposed Rule required an "[A]cquiring [F]und to obtain a certification from the insurance company issuing the separate account that it has determined that the fees borne by the separate account, [A]cquiring [F]und and [A]cquired [F]und, in the aggregate, are consistent with the standard set forth in section 26(f)(2)(A) of the [Investment Company] Act." The	Finally, with respect to separate accounts that fund variable insurance contracts that invest in an Acquiring Fund, the Final Rule requires an "[A]cquiring [F]und 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, [A]cquiring [F]und and

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	Condition Under Existing Exemptive Orders	Condition Under the Proposed Rule	Condition Under the Final Rule
		Proposing Release noted that, "The standard set forth in section 26(f)(2)(A) of the [Investment Company] Act 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."	[A]cquired [F]und, in the aggregate, are consistent with the standard set forth in section 26(f)(2)(A) of the [Investment Company] Act." The Adopting Release notes that, "The standard set forth in section 26(f)(2)(A) of the [Investment Company] Act 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."

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Master-Feeder Arrangements

The Adopting Release notes that this condition "would not prevent other funds from acquiring the voting securities of an [A]cquiring [F]und in amounts under 3%, which effectively creates a type of three-tier structure."

	Condition Under Existing Exemptive Orders	Condition Under the Proposed Rule	Condition Under the Final Rule
Complex Structures	Existing exemptive relief "[l]imits the ability of an Acquired Fund to invest in underlying funds (that is, it limits structures with three or more tiers of funds)."	The Proposed Rule included a condition that would "prohibit a fund that is relying on section 12(d)(1)(G) of the [Investment Company] Act or the [P]roposed [R]ule from acquiring, in excess of the limits in section 12(d)(1)(A), the outstanding voting securities of a fund that discloses in its most recent registration statement that it may be an [A]cquiring [F]und in reliance on proposed [R]ule 12d1-4." However, three-tier structures under a master-feeder arrangement where a fund invests all of its assets in an Acquiring Fund in reliance on Section 12(d)(1)(E) was permitted. The Proposed Rule also required a fund relying on the Proposed Rule (or a fund that "wants to preserve investment flexibility to rely on the rule") to disclose that it is an Acquiring Fund for purposes of the Proposed Rule in its registration statement. The Proposed Rule also included a condition that would generally "prohibit arrangements where an [A]cquired [F]und invests in other investment companies or private funds in excess of the limits	The Final Rule prohibits a fund that is relying on section 12(d)(1)(G) of the Investment Company Act or the Final Rule, "from acquiring, in excess of the limits in section 12(d)(1)(A), the outstanding voting securities of an [A]cquiring [F]und (a "second-tier fund") unless the second-tier funds makes investments permitted by the Final Rule" However, three-tier structures under a master-feeder arrangement where a fund invests all of its assets in an Acquiring Fund in reliance on Section 12(d)(1)(E) would be permitted. This limitation is generally consistent with the Proposed Rule, however, the Final Rule applies this limitation to investments in an Acquiring Fund, regardless of whether it disclosures in its registration statement that it may be an acquiring fund for purposes of the Final Rule (as such disclosure requirement is not included in

	Condition Under Existing Exemptive Orders	Condition Under the Proposed Rule	Condition Under the Final Rule
		in section 12(d)(1)(A)[,]" but also allowed "arrangements where the [A]cquired [F]und invests in other funds in certain enumerated circumstances." According to the Proposing Release, these circumstances are consistent with those contained in prior exemptive orders. Under the Proposed Rule, an Acquired Fund was allowed to (i) invest in another fund beyond the statutory limits "for short-term cash management purposes or in connection with interfund lending or borrowing transactions"; (ii) invest all of its assets in a master fund or invest in a wholly owned subsidiary; and (iii) receive fund shares as a dividend or as a result of a plan of reorganization.	the Final Rule). Consistent with the Proposed Rule, the Final Rule generally will "prohibit arrangements where an [A]cquired [F]und invests in other investment companies or private funds in excess of the limits in section 12(d)(1)(A)[,]" but would also allow "arrangements where an [A]cquired [F]und invests in other funds in certain enumerated circumstances." Under the Final Rule an Acquired Fund is allowed to invest in "securities of another investment company that is (i) acquired in reliance on section 12(d)(1)(E) of the [Investment Company] Act (i.e., master-feeder arrangements); (ii) acquired pursuant to rule 12d1-1; (iii) a subsidiary wholly-owned and controlled by the [A]cquired [F]und; (iv) received as a dividend or as a result of a plan of reorganization of a company; or (v) acquired pursuant to exemptive relief

	Condition Under Existing Exemptive Orders	Condition Under the Proposed Rule	Condition Under the Final Rule
			from the [SEC] to engage in interfund borrowing and lending transactions.” Additionally, According to the Adopting Release, the Final Rule includes a separate exception that will permit an Acquired Fund to invest up to 10% of its assets in other investment companies or private funds. The Adopting Release further notes that for the purposes of calculating this 10% bucket, investments by an acquired fund pursuant to the general exceptions discussed above, would not be included.

The Rescission of Rule 12d1-2 and Certain Exemptive Relief and Amendments to Rule 12d1-1

According to the Adopting Release, the SEC is rescinding Rule 12d1-2 in order to “create a more consistent and efficient regulatory framework for the regulation of fund of funds arrangements.” According to the Adopting Release, Rule 12d1-2 currently permits funds that are relying on section 12(d)(1)(G) 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”; and (iii) “acquire the securities of money market funds in reliance on [R]ule 12d1-1.” The Adopting Release notes that this rescission would require funds previously relying on section 12(d)(1)(G) to comply with the conditions in the Final Rule to continue to invest in the above types of investments previously provided for in Rule 12d1-2. Many commenters opposed the proposed rescission of Rule 12d1-2, with concerns that it may disrupt investment strategies, opportunities and operations or that it will

impact a fund's ability to utilize certain fund structures. The SEC determined to rescind Rule 12d1-2 "in order to harmonize the overall regulatory structure." Though this means there will be less flexibility for some funds relying on Section 12(d)(1)(G), Acquiring Funds will have more flexibility to invest in different types of funds under the Final Rule under a single set of conditions which are tailored to address the concerns that underlie Section 12(d)(1) of the Act.

The SEC, however, is adopting, as proposed, an amendment to Rule 12d1-1 to allow funds that rely on Section 12(d)(1)(G), to rely on the rule in order to provide the funds "with continued flexibility to invest in money market funds outside of the same group of investment companies despite the rescission of rule 12d1-2."

Further, according to the Adopting Release, the SEC is rescinding exemptive relief that permits investments in funds beyond the limits of 12(d)(1)(A), (B) and (C) of the Investment Company Act, other than in circumstances that are outside of the scope of the Final Rule, including relief related to: (i) interfund lending arrangements; (ii) affiliated insurance fund relief; (iii) certain transaction-specific relief; (iv) grantor trusts; and (v) fund of funds arrangements with managed risk provision and other relief related to Section 12(d)(1)(E). The SEC is also "rescinding exemptive relief under section 12(d)(1)(G) that permits an affiliated fund of funds to invest in assets that are beyond the scope of that statutory provision."

In order to give funds time to adapt to the new requirements, the rescission of Rule 12d1-2 and these exemptive orders will not occur until one year after the effective date of the Final Rule.

Additionally, according to the Adopting Release, no-action letters stating that the staff would not recommend an enforcement action under specific circumstances related to section 12(d)(1) will be withdrawn one year from the effective date of the Final Rule."

Exemption from Prohibition on Certain Affiliated Transactions

The Final Rule also provides an exemption from Section 17(a) of the Investment Company Act, which "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." The Adopting Release notes that, absent such relief, Section 17(a) would prohibit registered funds that hold "5% or more of the [A]cquired [F]und's securities from making any additional investments in the [A]cquired [F]und." Further, the Adopting Release notes that fund of funds arrangements that involve "funds that are part of the same group of investment companies or that have the same investment adviser (or affiliated investment advisers) also implicate the [Investment Company] Act's protections against affiliated transactions, regardless of whether an [A]cquiring [F]und exceeds the 5% threshold." Additionally, with respect to ETFs, Section 17(a) would prohibit "the delivery or deposit of basket assets on an in-kind basis by an affiliated fund (that is, by exchanging certain assets from the ETF's portfolio, rather than in cash)."

Commenters generally supported the exemption from Section 17(a), but requested that the Final Rule clarify the availability of the exemption "when an acquired ETF transacts on an in-kind basis with an affiliated Acquiring Fund." The Adopting Release provides clarification in this regard, noting that it is appropriate to permit ETFs to engage in in-kind purchase or redemption transactions and adopted a modified exemption from 17(a), which clarifies that the Final Rule provides relief from Section 17(a) for "ETFs to engage in in-kind purchase or redemption transactions with certain affiliated [A]cquiring [F]unds on the same basis that they would be permitted to engage in a cash purchase or redemption transactions with such affiliated [A]cquiring [F]und under the [R]ule." According to the Adopting Release, the Section 17(a) exemption is "limited in scope to those necessary for a fund of funds structure to operate under the [Final R]ule: and consistent with the relief provided under the exemptive orders."

Form Amendments

In addition, the Adopting Release notes that SEC has added a requirement to Form N-CEN, "a structured form that requires registered funds to provide census-type information to the [SEC] on an annual basis." According to the Adopting Release, the additional requirement would require "reporting if a management company [or UIT] relied on [R]ule 12d1-4 or the statutory exception in section 12(d)(1)(G) during the reporting period."

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The Final Rule will be effective 60 days after publication in the Federal Register and the compliance date for the amendments to Form N-CEN will be 425 days after publication in the Federal Register. Rescission of Rule 12d1-2 and the SEC's exemptive orders will be 1 year from the effective date of the Final Rule.

- **See a copy of the Press Release announcing the Final Rule**
- **See a copy of the Final Rule**

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