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Investment Management & Funds Regulatory Update - March 2026

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In this issue, we discuss a settled SEC enforcement action involving "season-and-sell" programs and new Division of Investment Management FAQs regarding the Fund of Funds Rule.

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Industry update

SEC Investment Management Division staff issues updated FAQs regarding Fund of Funds Rule

On March 5, 2026, SEC Investment Management Division staff (the Staff) updated its FAQs regarding compliance with Rule 12d1-4 under the Investment Company Act of 1940, as amended (the 1940 Act). The new FAQs provide additional clarification regarding (i) the requirement to enter into a fund of funds investment agreement when a management company acquires a fund under certain circumstances and (ii) whether debt securities issued by collateralized loan obligations (CLOs) should be counted towards the 10% bucket under Rule 12d1-4(b)(3)(ii) under the 1940 Act.

The requirement to enter into a fund of funds investment agreement

The first set of new FAQs addresses whether an acquiring fund is required to enter into a fund of funds investment agreement with an acquired fund when its acquisition of the acquired fund would exceed the 5% or 10% limits of Section 12(d)(1)(A)(ii) or (iii) of the 1940 Act but not the 3% limit of Section 12(d)(1)(A)(i) of the 1940 Act (assuming that the two funds do not share the same investment adviser).

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In its response, the Staff confirmed that an acquiring fund is required to enter into a fund of funds investment agreement with an acquired fund under such circumstance. The Staff emphasized that the requirement to enter into a fund of funds investment agreement under Rule 12d1-4(b)(2)(iv) applies if an acquiring fund is relying upon the rule for an exemption from Section 12(d)(1)(A)(i), (ii), or (iii).

However, the Staff also noted that no findings under Rule 12d1-4(b)(2)(i) would be required if an acquiring fund does not exceed the 3% limit of Section 12(d)(1)(A)(i) with respect to a specific acquired fund. Thus, the fund of funds investment agreement in such case would not need to include the material terms related to such findings that would otherwise be required under Rule 12d1-4(b)(2)(iv)(A), as such terms would not exist.

The Staff highlighted the purpose of Rule 12d1-4 under the 1940 Act, which is, in part, to empower funds relying on the rule to negotiate and tailor appropriate terms to protect their interest in a fund of funds arrangement. The Staff believes that requiring the fund of funds investment agreement in this situation facilitates the negotiations contemplated by the SEC, even when no findings are required under the rule.

The Staff noted that its response to this question does not change when the acquiring fund is a unit investment trust.

Separately, the Staff confirmed that an acquiring fund is not required to enter into fund of funds investment agreements with acquired funds in which it had invested prior to relying on Rule 12d1-4, provided that the acquiring fund does not purchase additional shares of such acquired funds in reliance on Rule 12d1-4. If the acquiring fund subsequently purchases additional shares of such an acquired fund in reliance on Rule 12d1-4, an agreement would be necessary.

Whether to count debt securities issued by CLOs towards the 10% bucket under Rule 12d1-4(b)(3)(ii)

The second set of new FAQs addresses whether the Staff would recommend enforcement action if an acquired fund does not count investments in debt securities issued by CLOs towards the 10% bucket in Rule 12d1-4(b)(3)(ii).

The Staff explained that Rule 12d1-4(b)(3) was generally designed "to prevent potential increases in duplicative fees and expenses, and to avoid the investor confusion" that can result from complex multi-tier fund structures as "multi-tier structures can obfuscate the fund's investments, fees, and related risks."

The Staff recognized, however, that debt securities issued by CLOs are structurally and operationally different from entities traditionally considered pooled investment vehicles for purposes of these underlying complex multi-tier fund structure concerns, such as hedge funds and private equity funds. For example, the Staff noted that: "CLOs' debt securities are backed by the cash flows of an underlying pool of collateral and, unlike equity security holdings, which economically expose investors to the collateral, CLO debt securities earn distributed principal and income on the financing costs of the collateral."

As such, according to the FAQ, the Staff does not believe that debt securities issued by CLOs are the type of "'fund-like' investment where the expectations of the acquiring fund's shareholders would be frustrated if these shareholders could not look through the multi-tier structure to determine the nature and value of the CLO holdings." The Staff therefore stated that it would not recommend enforcement action if an acquired fund does not count investments in debt securities issued by CLOs towards the 10% bucket in Rule 12d1-4(b)(3)(ii).

Litigation

SEC charges adviser over principal trade practices in "season-and-sell" program

On February 25, 2026, the SEC announced a settled enforcement action against Madison Capital Funding LLC (Madison), formerly a registered investment adviser, in connection with its COVID-era season-and-sell loan transactions. The SEC's order, available here, highlights the SEC's continued focus on advisers' valuation practices and conflicts management in principal transactions—particularly in times of market stress.

According to the SEC, Madison engaged in a series of principal transactions between March and May 2020 involving the sale of loans off its balance sheet through a season-and-sell program. The SEC found that the loans were not transferred at "fair value" or "fair market value," as required by Madison's contractual obligations, disclosures, and representations to a third-party independent agent that approved the transactions. The SEC alleged that the extraordinary market volatility during the onset of the COVID-19 pandemic undermined the reasonableness of Madison's approach to fair value

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determinations.

SEC's findings

The SEC's order describes Madison's long-standing practice of pricing loans for season-and-sell transactions at par value less unamortized loan fees, unless a loan had been downgraded under Madison's proprietary credit scoring model. While an independent third-party agent approved such transactions, the agent did not independently value the loans and instead relied on Madison's representation that the pricing reflected fair market value given then-current market conditions. This same approach was used during the early months of the pandemic, even as credit conditions deteriorated sharply.

During the March to May 2020 period, Madison enhanced its portfolio monitoring and implemented a daily credit review to confirm that none of the loans being sold had been, or were expected to be, downgraded. However, according to the SEC, Madison did not reassess the valuation of loans to confirm that the proposed sales continued to be at "fair value" despite the substantial dislocation in credit markets at that time.

Sanctions and remediations

The SEC's order notes that 143 loans were transferred as part of the relevant transactions, all but one of which continued to perform or were fully repaid. Nonetheless, Madison was required to pay $5 million in remediation, which the SEC described as representing the aggregate difference between the sale prices and fair value at the time, plus approximately $200,000 in interest and a $900,000 civil penalty.

Key takeaways

The order underscores the SEC's continuing emphasis on valuation governance and procedural rigor in principal transactions, especially under atypical market conditions. Notably, the SEC did not object to Madison's use of a third-party agent or to its decision not to obtain independent valuations. Indeed, Madison's advisory agreements explicitly permitted principal transactions "without any third-party valuation." The SEC instead focused on the firm's failure to ensure that its pricing methodology continued to reflect "fair value as reasonably determined by Madison" during a period of market disruption.

The case illustrates that good process and contemporaneous documentation are critical to supporting the reasonableness of valuation determinations—particularly where standard pricing assumptions may no longer apply. The SEC's action suggests that advisers must be especially vigilant in testing and updating valuation methodologies when market conditions change rapidly, even absent investor losses.

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