October 19, 2020

SEC Adopts Final Rule to Update the Regulatory Framework for Fund of Funds Arrangements

Final Rule Establishes Rules-Based Regime to Permit Funds to Acquire Shares of Other Funds in Excess of Limits in Section 12(d)(1) of the Investment Company Act

INTRODUCTION

On October 7, 2020, the Securities and Exchange Commission (the "SEC") unanimously voted to adopt new rule 12d1-4 under the Investment Company Act of 1940 (the "Investment Company Act") and related amendments intended to streamline and enhance the regulatory framework for funds that invest in other funds ("fund of funds" arrangements).

The final rule reflects a continued effort by the SEC's Division of Investment Management under the leadership of Director Dalia Blass to create, where deemed appropriate, consistent rules-based regulatory frameworks governing various aspects of the organization and operation of funds.[1] The adoption of the final rule also marks the completion of one of four key outstanding rule proposals from the Division of Investment Management—in addition to the proposals on funds' use of derivatives, fund valuation practices and investment adviser advertising and solicitation—that may be finalized later this year.[2] The final rule was adopted nearly two years after the issuance of the proposed rule (the "Proposal"), reflecting the complexity of the rule and the underlying regulatory regime and the substantial engagement in the rulemaking process by the fund industry, including registered funds, private funds and business development companies, as well as the need for the SEC to consider the various fund structures that have developed over many years and may be impacted by the rule.

Notably, the final rule eliminates the "redemption limit" that was included in the Proposal, which was strongly opposed by numerous commenters, and that change should be well received by the fund industry.

However, the final rule contains a number of important differences from both the existing SEC exemptive orders and the Proposal, which, as the SEC acknowledged, may require substantial restructuring of certain current fund of funds arrangements. In particular, the SEC declined to make a special accommodation for "central funds" as requested by a number of commenters, although the SEC did provide flexibility for acquired funds to invest in other funds, including central funds, up to 10% of the acquired fund's total assets.

As discussed further below, the final rule will also have implications for fund boards of directors, including with respect to their oversight obligations of fund of funds arrangements under rule 38a-1.

SUMMARY OF THE FINAL RULE AND RELATED SEC ACTIONS

Subject to certain conditions, the final rule allows registered investment companies and business development companies ("BDCs") to acquire the shares of another fund in excess of the limits prescribed in section 12(d)(1) of the Investment Company Act without obtaining an individual exemptive order.[3] The final rule includes several modifications to the December 2018 proposal (the "Proposal")[4] designed to increase the workability of the rule's requirements, while enhancing protections for investors in fund of funds arrangements.

For an acquiring fund to rely on rule 12d1-4, it must comply with certain conditions designed to enhance investor protections while providing funds with flexibility to meet their investment objectives. Specifically, rule 12d1-4:

- prohibits an acquiring fund and its "advisory group" from controlling an acquired fund (except in limited circumstances);
- requires an acquiring fund that holds more than 25% of the outstanding voting securities of an open-end fund or unit investment trust (due to a decrease in the outstanding securities of the acquired fund) or more than 10% of the outstanding voting securities of a closed-end fund generally to vote those securities using "mirror voting";
- requires certain evaluations and findings to be made by both the acquiring fund and the acquired fund before the acquiring fund invests, which differ depending upon whether the fund is the acquiring or acquired fund, and whether it is a management company, unit investment trust or a separate account funding variable insurance contracts;
- requires funds that do not share the same investment adviser to enter into a fund of funds investment agreement memorializing the terms of the arrangement; and
- generally prohibits funds from creating three-tier fund of funds structures, except in certain circumstances, including in a change from the Proposal a new exception that will permit an acquired fund to invest up to 10% of its total assets in other funds (including private funds) without restriction.

Notably, the final rule eliminates the "redemption limit" that was included in the Proposal that would have restricted an acquiring fund that acquires more than 3% of an acquired fund's outstanding shares from redeeming more than 3% of an acquired fund's total outstanding shares in any 30-day period.

In connection with the adoption of new rule 12d1-4, the SEC is rescinding rule 12d1-2 under the Investment Company Act, which allows funds that primarily invest in funds within the same fund group to invest in unaffiliated funds and non-fund assets, as well as the exemptive orders granting relief from sections 12(d)(1)(A), (B), (C), and (G) of the Investment Company Act to establish fund of funds arrangements, with limited exceptions. The SEC is also adopting related amendments to rule 12d1-1 to allow funds that primarily invest in funds within the same fund group to continue to invest in unaffiliated money market funds, and to Form N-CEN to require funds to report whether they relied on rule 12d1-4 or the statutory exception in section 12(d)(1)(G) of the Investment Company Act during the applicable reporting period.

The final rule and the amendments to rule 12d1-1 and Form N-CEN will become effective 60 days after publication in the Federal Register. However, the compliance date for the amendments to Form N-CEN will be 425 days after their publication in the Federal Register (one year after the effective date of the amendments), and the rescission of rule 12d1-2 and the Commission's exemptive orders will be effective one year from the effective date of the rule.

BACKGROUND

The Investment Company Act imposes certain restrictions that limit fund of funds arrangements in order to prevent an acquiring fund from controlling the assets of an acquired fund and using those assets to enrich the acquiring fund at the expense of acquired fund shareholders. Specifically, section 12(d)(1) imposes limits on the amount of securities that both registered funds and private funds may acquire of another fund.[5] Further, section 12(d)(1)(B) prohibits a registered open-end fund, and any principal underwriter thereof or broker-dealer registered under the Securities Exchange Act of 1934, from knowingly selling securities to any other investment company if, after the sale, the acquiring fund (together with companies it controls or with other funds, as applicable) would own more than a certain percentage of the acquired fund's outstanding voting securities.[6] However, the Investment Company Act contains three statutory exceptions that permit different types of fund of funds arrangements subject to certain conditions,[7] and grants the SEC the authority to exempt any person, security or transaction, or any class or classes of transactions, from the restrictions of section 12(d)(1) if the exemption is consistent with the public interest and the protection of investors. This authority has been used by the SEC over the years to adopt three rules of general applicability[8] and to issue a number of individual exemptive orders.

The SEC notes that both funds and retail investors have increasingly utilized fund of funds arrangements to conveniently allocate and diversify investments. According to SEC staff estimates, approximately 40% of all registered funds hold an investment in at least one fund, and total net assets in mutual funds that invest primarily in other mutual funds have grown from $469 billion in 2008 to $2.54 trillion in 2019. However, fund of funds have operated under a patchwork of statutory provisions, SEC rules, SEC no-action letters, individual exemptive orders and industry practices.

In December 2018, the SEC proposed rule 12d1-4 to establish a comprehensive regulatory framework governing fund of funds. The final rule was adopted with several modifications to the Proposal, which are further discussed below.

SUMMARY OF THE FINAL RULE

Rule 12d1-4 permits a registered investment company or business development company ("BDC") (collectively, "acquiring funds") to acquire the securities of any other registered investment company or BDC (collectively, "acquired funds") in excess of the limits in section 12(d)(1) of the Investment Company Act, subject to the conditions discussed below. As a result, a broader set of funds than was previously permitted by the SEC's exemptive orders, including open-end funds, exchange-traded funds ("ETFs"), unit investment trusts ("UITs"), closed-end funds and BDCs, can rely on rule 12d1-4 as acquiring funds and acquired funds.[9] However, the final rule will not permit private funds and unregistered investment companies, such as foreign funds, to rely on the rule as acquiring funds, despite advocacy efforts by a number of commenters.[10]

The final rule also provides an exemption from section 17(a) of the Investment Company Act, which generally prohibits affiliate transactions and would otherwise prohibit an acquiring fund that holds 5% or more of the acquired fund's securities to make additional investments in the acquired fund, as well as a limited exemption for in-kind transactions for certain affiliated persons of ETFs.

A. LIMITS ON CONTROL AND VOTING

1. Limits on Control

Rule 12d1-4 will prohibit an acquiring fund and its "advisory group"[11] from controlling, individually or in the aggregate, an acquired fund, except in certain limited circumstances. 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"[12] The final rule's restrictions on control reflect the rebuttable presumption in the Investment Company Act that any person who, directly or indirectly, beneficially owns more than 25% of the voting securities of a company is presumed to control the company and that any person who does not own more than 25% of the voting securities of a company is presumed to not control it. These presumptions continue until the SEC makes a final determination to the contrary by order either on its own motion or on application by an interested person.[13] The Release notes that "no person may rely on the presumption that less than 25% ownership is not control when, in fact, a control relationship exists under all the facts and circumstances."[14]

2. Voting Provisions

Rule 12d1-4 will also require an acquiring fund and its advisory group to use "mirror voting" in the following circumstances:

- if the acquiring fund and its advisory group (in the aggregate) holds more than 25% of the outstanding voting securities of an acquired open-end fund or UIT due to a decrease in the outstanding securities of the acquired fund; and
- if the acquiring fund and its advisory group (in the aggregate) holds more than 10% of the outstanding voting securities of a closed-end fund or BDC.

Mirror voting requires the acquiring fund to vote the shares held by it and its advisory group in the same proportion as the vote of all other holders of the acquired fund. The final rule was revised from the Proposal, which would have applied a uniform 3% ownership threshold across all types of acquired funds to trigger the voting conditions, in response to comments that recommended the ownership threshold be higher and differ depending on the type of acquired fund. Recognizing that open-end funds and UITs hold shareholder meetings infrequently while closed-end funds hold frequent shareholder meetings, which may raise greater concerns of undue influence associated with shareholder votes, the final rule adopts the lower 10% ownership threshold for closed-end funds. The mirror voting requirement will apply to open-end funds and UITs only when ownership by an acquiring fund and its advisory group exceeds 25% of the outstanding voting securities. This level of ownership would only occur as a result of a decrease in the outstanding voting securities of the acquired fund after the acquiring fund had made an investment, as the limitation on control discussed above will prohibit acquiring funds from acquiring shares of an acquired fund in excess of the 25% threshold.

In another change from the Proposal, the final rule provides for the use of "pass-through voting" (*i.e.*, seeking and voting in accordance with instructions from the acquiring fund's security holders) only when acquiring funds are the only shareholders of an acquired fund.

3. Exceptions to the Control and Voting Limitations

The control and voting conditions do not apply when: (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.[15] "Group of investment companies" means any two or more registered investment companies or BDCs that hold themselves out to investors as related companies for investment and investor services.[16]

B. FUND FINDINGS AND FUND OF FUNDS INVESTMENT AGREEMENT

The Proposal would have restricted an acquiring fund that acquires more than 3% of an acquired fund's outstanding shares (*i.e.*, the statutory limit) 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 (the "redemption limit"). The SEC proposed the redemption limit to address concerns that an acquiring fund could threaten large-scale redemptions as a means of exercising undue influence over an acquired fund, and would have limited an acquiring fund's ability to quickly redeem or tender a large volume of

acquired fund shares. The redemption limit faced significant opposition from many commenters concerned with, among other things, operational or administrative challenges, the acquiring fund's ability to quickly respond to market conditions, as well as liquidity and cost considerations. In response to commenters, the final rule replaces the redemption limit with requirements to make certain evaluations and findings on the arrangement and to enter into fund investment agreements that include certain prescribed terms.

1. Required Evaluations and Findings

Rule 12d1-4 will require investment advisers to acquiring and acquired funds that are management companies to make certain findings regarding the fund of funds arrangement, after considering specific enumerated factors. The rule also requires alternative findings regarding acquiring funds that are UITs and a certification regarding separate accounts funding variable insurance contracts (collectively, "Fund Findings").

For acquired funds that are management companies, the acquired fund's investment adviser must, prior to the initial acquisition of an acquired fund in excess of the limits in section 12(d)(1)(A)(i), find that any undue influence concerns associated with the acquiring fund's investment in the acquired fund are reasonably addressed, after considering the following factors:

- the scale of contemplated investments by the acquiring fund and any maximum investment limits;
- the anticipated timing of redemption requests by the acquiring fund;
- whether, and under what circumstances, the acquiring fund will provide advance notification of investment and redemptions; and
- 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.

In order to make the required finding, an acquired fund's adviser also would need to consider any other relevant regulatory requirements, such as liquidity risk and risk management under rule 22e-4.

For acquiring funds that are management companies, the acquiring fund's investment adviser, prior to the initial acquisition of voting securities of an acquired fund in excess of the limits in section 12(d)(1)(A)(i), must evaluate the complexity of the fund of funds structure and its aggregate fees and expenses and make a finding that the fees and expenses are not duplicative of the fees and expenses of the acquired fund. In evaluating the complexity of a fund of funds structure, the adviser should consider whether the resulting structure would make it difficult for shareholders to appreciate the fund's exposures and risks or circumvent the acquiring fund's investment restrictions and limitations, and whether an acquired fund invests in other funds, which may create additional complexity. For both acquiring funds and acquired funds, the required analysis, and any findings based thereon, will be subject to the adviser's fiduciary duty to act in the best interest of each fund it advises.

In addition, the adviser to a fund that is a management company must report its evaluation, finding, and the basis for its evaluation or finding to the fund's board of directors no later than the next regularly scheduled

board meeting.[17] Boards will be required to review these arrangements at inception as part of their oversight responsibilities, and ongoing review of these arrangements, which must be conducted at least annually, will become a part of the board's regular compliance oversight under rule 38a-1. With respect to this condition, the SEC stated that it "continue[s] to believe that the board of directors provides an additional layer of protection for acquiring and acquired funds that are management companies and their respective investors against the abuses historically associated with fund of funds arrangements."[18]

When the acquiring fund is a UIT, alternative finding conditions apply. On or before the date of initial deposit of portfolio securities into a registered UIT, the UIT's principal underwriter or depositor must find that the fees of the UIT do not duplicate the fees and expenses of the acquired funds that the UIT holds or will hold at the date of deposit, based on an evaluation of the complexity of the structure and the aggregate fees and expenses associated with the UIT's investment in acquired funds.

With respect to a separate account funding variable insurance contracts that invests in an acquiring fund, the final rule will require an acquiring fund 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, acquiring fund and acquired fund, in the aggregate, are reasonable in relation to the services rendered, the expenses expected to be incurred and the risks assumed by the insurance company.

2. Required Fund of Funds Investment Agreements

Rule 12d1-4 will require acquiring funds and acquired funds, prior to the purchase of acquired fund shares in excess of section 12(d)(1)'s limits, to enter into a fund of funds investment agreement to memorialize the terms of the arrangement (including terms that serve as a basis for the required findings) when the acquiring and acquired funds do not share an investment adviser (a "fund of funds investment agreement").

A fund of funds investment agreement must include three specific provisions:

- any material terms necessary for the adviser, underwriter or depositor to make the Fund Findings where the funds involved include management companies or UITs;
- a termination provision whereby either party can terminate the agreement with advance written notice within a period no longer than 60 days; and
- a provision requiring an acquired fund to provide the acquiring fund with fee and expense information to the extent reasonably requested.

The fund of funds investment agreements differ from the "participation agreements" that were generally required under SEC exemptive orders. Participation agreements under SEC exemptive orders obligated both funds in a fund of funds arrangement (and their investment advisers) to fulfill their responsibilities under the order, which required a participation agreement to state that the funds' boards and their investment advisers understand the terms and conditions of the order and agree to fulfill their responsibilities under the order. In contrast, a fund of funds investment agreement under the final rule need

not include such contractual provisions because parties to the agreement will be required to comply with the rule's conditions.

C. LIMITS ON COMPLEX STRUCTURES

Rule 12d1-4 includes conditions designed generally to restrict three-tier structures, with certain exceptions. While acknowledging that three-tier structures "may provide efficient and cost-effective exposure to certain market segments in certain circumstances," the SEC notes that it "continue[s] to believe that multi-tier structures can obfuscate the fund's investments, fees, and related risk."[19]

Specifically, the rule prohibits a fund that is relying on section 12(d)(1)(G) of the Investment Company Act or rule 12d1-4 from acquiring, in excess of the limits in section 12(d)(1)(A), the outstanding voting securities of an acquiring fund (a "second-tier fund"), unless the second-tier fund meets the exceptions discussed below. The SEC notes that this condition is generally more comprehensive and, therefore, limiting, than the conditions in its orders, and "addresses certain multi-tier arrangements that have emerged."[20] However, this condition will not prevent a fund from investing all of its assets in an acquiring fund in reliance on section 12(d)(1)(E), thus preserving the ability for funds to establish master-feeder arrangements.

In addition, the rule generally will prohibit arrangements where an acquired fund invests in other investment companies or private funds in excess of the limits in section 12(d)(1)(A). Specifically, no acquired fund may purchase or otherwise acquire the securities of an investment company or private fund if immediately after such purchase or acquisition, the securities of investment companies and private funds owned by the acquired fund have an aggregate value in excess of 10% of the value of the total assets of the acquired fund, subject to certain enumerated exceptions.

The rule will allow limited circumstances where an acquired fund may invest in another fund, largely consistent with categories that have been permitted under existing SEC exemptive orders or no-action letters. The categories include securities of another investment company that is:

- acquired in reliance on section 12(d)(1)(E) of the Investment Company Act (*i.e.*, master-feeder arrangements);
- acquired pursuant to rule 12d1-1 for any investment purpose;[21]
- a subsidiary wholly owned and controlled by the acquired fund;
- received as a dividend or as a result of a plan of reorganization of a company; or
- acquired pursuant to exemptive relief from the SEC to engage in interfund borrowing and lending transactions.

In addition to these enumerated exceptions, in a change from the Proposal, the rule will allow an acquired fund to invest up to 10% of its total assets in other funds (including private funds), regardless of the size of the investment in any one fund, the purpose of the investment or the types of underlying funds (the "10% Bucket"). The 10% Bucket is measured at the time of acquisition, and therefore acquired funds will not be

required to dispose of existing investments due to changes in the market values of underlying investments. In addition, investments by an acquired fund pursuant to the enumerated exceptions listed above will not be included for purposes of calculating the 10% Bucket. If an acquired fund wishes to acquire other underlying funds in excess of the 10% Bucket, the acquired fund may seek exemptive relief from the SEC.

D. RELATED ACTIONS

The SEC is also taking several related actions in connection with the adoption of new rule 12d1-4 to create a consistent and streamlined regulatory framework for fund of funds arrangements.

1. Rescission of Rule 12d1-2 and Certain Exemptive Relief

The SEC is rescinding rule 12d1-2, which permits a registered open-end fund or UIT that primarily invests in funds within the same "group investment companies" to invest in (i) unaffiliated funds that are not part of the same group of investment companies, (ii) non-fund assets such as stocks, bonds and other securities, and (iii) money market funds in reliance on rule 12d1-1. Rule 12d1-2 will be rescinded one year after the effective date of the final rule to mitigate the impact on existing fund of funds arrangements. Existing funds relying on rule 12d1-2 will not be grandfathered or exempted past this one-year period. The SEC also is rescinding exemptive orders permitting funds to invest in funds within the same group of investment companies and closed-end funds to a greater extent and in other financial instruments that may not be "securities" under the Investment Company Act. As a result, funds wishing to create certain types of fund of funds arrangements that exceed the statutory limitations will be required to rely on rule 12d1-4 and comply with its associated conditions.

2. Amendments to Rule 12d1-1

The SEC is amending rule 12d1-1 to allow funds that primarily invest in funds within the same group investment companies to continue to invest in unaffiliated money market funds despite the rescission of rule 12d1-2, discussed above.

3. Amendments to Form N-CEN

The SEC is also amending Form N-CEN to require funds to report whether they relied on rule 12d1-4 or the statutory exception in section 12(d)(1)(G) of the Investment Company Act during the applicable reporting period.

CERTAIN CONSIDERATIONS

As noted above, although the rule incorporates elements from the SEC's current exemptive orders, the final rule contains a number of important differences from both the existing exemptive orders and the Proposal that may require substantial restructuring of certain fund of funds arrangements. Fund sponsors will need to consider carefully—and quickly, as rule 12d1-2 and existing exemptive relief will be rescinded one year from the effective date of the new rule—the implications of the final rule on the structure of their funds and

their fund's investments in other funds. In addition, investment managers will need to consider how the rule may impact their advised funds' ability to efficiently allocate, diversify and hold investments. As a specific example, although the SEC declined to make a special accommodation for "central funds" as requested by a number of commenters, the SEC did provide flexibility for acquired funds to invest in other funds, including central funds, up to the limit provided in the 10% Bucket exception. When the exemptive relief[22] that acquired funds have relied on to invest in central funds beyond statutory limits is rescinded one year from the effective date of the final rule, central funds would also be limited to the 10% Bucket.

BDC sponsors in particular will wish to consider what additional flexibility may be provided in the final rule to structure fund of fund arrangements involving BDCs, as SEC exemptive relief permitting investments by BDCs in acquired funds and by acquiring funds in BDCs beyond the limits in section 12(d)(1) has historically been more limited.[23]

Finally, fund boards will need to consider the rule's implications on their oversight responsibilities. In particular, while fund boards will no longer have the obligations of the type specified in the exemptive applications and orders,[24] the final rule requires advisers to a management company to report its required Fund Findings (including the basis for such Fund Findings) to the fund's board of directors. Boards will be required to review these arrangements at inception as part of their oversight responsibilities, and ongoing review of these arrangements will become a part of the board's regular compliance oversight under rule 38a-1.[25] Subsequent reporting to and review by a fund's board regarding the Fund Findings will need to be conducted at least annually under the fund's compliance program. Although not discussed in any detail in the Release, SEC expectations for the board's engagement and oversight of these matters may evolve over time.[26]

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ENDNOTES

1 *See, e.g.,* Exchange-Traded Funds, Investment Company Act Release No. 33646 (Sept. 25, 2019); Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles, Investment Company Act Release No. 5413 (Nov. 25, 2019) (proposed rule).

2 *See* Dalia Blass, Speech: PLI Investment Management Institute (July 28, 2020), *available at* https://www.sec.gov/news/speech/blass-speech-pli-investment-management-institute ("we plan to make recommendations for next steps to the Commission on all of the outstanding proposals in our area, including fund of funds arrangements, funds' use of derivatives, fund valuation practices, and investment adviser advertising and solicitation") (internal citations omitted).

3 SEC, *Fund of Funds Arrangements* (Oct. 7, 2020), *available at* https://www.sec.gov/rules/final/2020/33-10871.pdf (the "Release").

4 Proposed Rule, Fund of Funds Arrangements, 84 Fed. Reg. 1286 (Feb. 1, 2019), *available at* https://www.govinfo.gov/content/pkg/FR-2019-02-01/pdf/2018-27924.pdf.

5 A registered fund (and companies, including funds, it controls) is prohibited from acquiring more than 3% of another fund's outstanding voting securities, investing more than 5% of its total assets in any one fund or investing more than 10% of its total assets in funds generally. 15 U.S.C. 80a-12(d)(1)(A). Sections 3(c)(1) and 3(c)(7) of the Investment Company Act subject private funds to the 3% limitation on investments in registered funds. 15 U.S.C. 80a-3(c)(1) and 3(c)(7)(D). In addition, section 60 of the Investment Company Act makes section 12(d) applicable to a BDC to the same extent as it if were a registered closed-end fund. 15 U.S.C. 80a-60.

6 Specifically, the acquiring fund may not, together with the companies it controls, own more than 3% of the acquired fund's outstanding voting securities or, together with other funds (and the companies they control), own more than 10% of the acquired fund's outstanding voting securities. 15 U.S.C. 80a-12(d)(1)(B).

7 15 U.S.C. 80a-12(d)(1)(E) (permitting master-feeder arrangements whereby an acquiring fund invests all of its assets in a single fund); 15 U.S.C. 80a-12(d)(1)(F) (permitting a fund to take small positions (up to 3% of another fund's securities) in an unlimited number of other funds); 15 U.S.C. 80a-12(d)(1)(G) (permitting an open-end fund or unit UIT to invest in other open-end funds and UITs that are in the "same group of investment companies").

8 Rule 12d1-1 (amended by the final rule) allows funds to invest in shares of money market funds in excess of the limits of section 12(d)(1). Rule 12d1-2 (rescinded by the final rule) provided funds relying on section 12(d)(1)(G) with greater flexibility to invest in other types of securities. Rule 12d1-3 allows acquiring funds relying on section 12(d)(1)(F) to charge sales loads greater than 1.5%.

9 For example, the 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). The rule similarly will increase permissible investments for closed-end funds beyond ETFs to allow them to invest in open-end funds, UITs, other closed-end funds and BDCs, in excess of the section 12(d)(1) limits. In addition to ETFs, BDCs also will be permitted to invest in open-end funds, UITs, other BDCs, other closed-end funds and exchange-traded managed funds ("ETMFs"). Finally, the rule will allow ETMFs to invest in open-end funds, UITs, BDCs and other closed-end funds.

10 In this regard, the SEC stated that it "do[es] not have sufficient experience tailoring conditions for private funds' and unregistered investment companies' investments in registered funds to address in a rule of general applicability the concerns such funds present as acquiring funds," and that "it would be more appropriate to consider designing protective conditions through the exemptive application process" for such funds. Release at 20.

ENDNOTES (CONTINUED)

11 Rule 12d1-4(d) defines "advisory group" as "either: (1) an acquiring fund's investment adviser or depositor, and any person controlling, controlled by, or under common control with such investment adviser or depositor; or (2) an acquiring fund's investment sub-adviser and any person controlling, controlled by, or under common control with such investment sub-adviser."

12 15 U.S.C. 80a-2(a)(9). The Release notes that a determination of control is not based solely on ownership of voting securities of a company and depends on the facts and circumstances of the particular situation, which may include the dominating persuasiveness of one or more persons, the act or process that is effective in checking or directing action or exercising restraint or preventing free action, and the latent existence of power to exert a controlling influence. *See* Release at 36.

13 15 U.S.C. 80a-2(a)(9); Release at n.98.

14 Release at n.99 (*citing* Exemption of Transactions by Investment Companies with Certain Affiliated Persons, Investment Company Act Release No. 10698 (May 16, 1979), at n.2).

15 Rule 12d1-4(b)(1)(iii).

16 Whether a group of funds sharing a common adviser or having advisers that are all control affiliates could satisfy the "holding out" prong of the definition would depend on the totality of communications with investors by or on behalf of the fund. *See* Release at 57.

17 While the acquiring fund's adviser must make the applicable Fund Findings (and ensure that the required fund of funds investment agreement is entered into) prior to initial investment, the adviser need not report the Fund Findings to the fund's board until the next regularly scheduled board meeting.

18 Release at 90.

19 Release at 107.

20 Release at 108.

21 The Proposal included a more limited exception for investments for "short-term cash management purposes" pursuant to 12d1-1. The final rule has been modified to eliminate the phrase "short-term cash management purposes," which will provide acquired funds with additional flexibility to invest in funds pursuant to rule 12d1-1 for any investment purpose.

22 Franklin Templeton Investments, Staff No-Action Letter (pub. avail. April 3, 2015); Thrivent Financial for Lutherans and Thrivent Asset Management LLC, Staff No-Action Letter (pub. avail. Sep. 27, 2016).

23 *See* Release at 12-17 ("For example, the 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)…BDCs, which currently may invest in ETFs in excess of the section 12(d)(1) limits, also will be permitted to invest in open-end funds, UITs, other BDCs, other closed-end funds and ETMFs.").

24 Recent exemptive orders permitting fund of funds arrangements have imposed a number of requirements on the boards of both funds that invest in unaffiliated funds (each, a "Fund of Funds") and unaffiliated funds in which a Fund of Funds invests above the limits imposed by the Investment Company Act ("Unaffiliated Investment Companies"). For example, the board of a Fund of Funds, including a majority of its independent members, must: (i) adopt procedures reasonably designed to ensure that the adviser and any subadviser to the Fund of Funds are conducting the investment program of the Fund of Funds without taking into account any consideration received by the Fund of Funds or certain affiliates thereof from an Unaffiliated Investment Company or certain affiliates thereof in connection with any services or transactions; and (ii) before approving any investment advisory contract find that the advisory fees charged under the contract are based on services provided that are in addition to, rather than duplicative of, services provided under the advisory contract(s) of any underlying fund in which the Fund of Funds may invest. Once an investment by a Fund of Funds in the securities of the Unaffiliated Investment Company exceeds the limit of Section 12(d)(1)(A)(i), the Board of the Unaffiliated Investment Company, including its independent

members, must: (A) determine that any consideration paid by the Unaffiliated Investment Company to the Fund of Funds or certain affiliates of the Fund of Funds in connection with any services or transactions: (a) is fair and reasonable in relation to the nature and quality of the services and benefits received by the Unaffiliated Investment Company; (b) is within the range of consideration that the Unaffiliated Investment Company would be required to pay to another unaffiliated entity in connection with the same services or transactions; and (c) does not involve overreaching on the part of any person concerned; and (B) adopt procedures reasonably designed to monitor any purchases of securities by the acquired fund in an affiliated underwriting and review those purchases no less frequently than annually, and consider specified factors in connection with such review. In addition, the participation agreement that the Fund of Funds and the Unaffiliated Investment Company must enter into before investments in excess of Section 12(d)(1)(A)(i) are made must include a statement that the boards and investment adviser of each fund understand the terms and conditions of the order and agree to fulfill their responsibilities under the order. *See, e.g.*, ETF Managers Trust, et al., Investment Company Act Release No. 33823 (Mar. 24, 2020) (order) and related application (January 6, 2020), *available at* https://www.sec.gov/Archives/edgar/data/1467831/000161577420000086/s122364_40app.htm.

25 Compliance policies and procedures required under 38a-1 will need to be updated to be reasonably designed to ensure compliance with the final rule.

26 In particular, fund boards should be mindful of any additional guidance relating to fund board oversight of fund compliance policies and procedures pursuant to rule 38a-1 that the SEC may provide in the adopting release for the final valuation rule that may be adopted in the coming months. The proposing release for the valuation rule included considerable discussion of board oversight matters. *See* Good Faith Determinations of Fair Value, Investment Company Act Release No. 33845 (Apr. 21, 2020) (proposed rule), 27-28 and 34-35, *available at* https://www.sec.gov/rules/proposed/2020/ic-33845.pdf.

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