Blogs
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Asset Management ADVocate

SEC Proposes Potentially Broadening and Disruptive New Fund-of-Funds Framework

On December 19, 2018, the SEC released a set of rule proposals (the "Proposals") intended to streamline the regulatory framework for fund-of-funds ("FOF") arrangements under the Investment Company Act of 1940 (the "1940 Act"). Investment advisers managing FOFs should consider looking closely with counsel at the impact these Proposals could have on their businesses and compliance programs. They might also consider responding to the substantive comment requests included in the Proposals. Section 12(d)(1) of the 1940 Act generally limits the percentage of assets that registered investment companies (mutual funds, ETFs, closed-end funds and UITs) and BDCs ("acquiring funds") may invest in other registered funds ("acquired funds"), and to the percentage of an acquired fund's shares that may be held by other funds, unless the funds can rely on a statutory exception or SEC exemptive rule or order. In the Proposal, the SEC estimates that nearly half of all registered funds currently rely on a mosaic of different rules and exemptive orders with varying conditions to invest in or allow investments by other funds. The Proposals are an effort to make the FOF regulation more consistent and efficient, particularly for similarly situated funds.

In with the New

Proposed new Rule 12d1-4 under the 1940 Act would allow registered funds to go beyond the limits of Section 12(d)(1) as acquiring or acquired funds, and to invest in other types of securities, without obtaining an exemptive order. Rule 12d1-4 would also exempt investments in an affiliated fund from the prohibitions of Section 17(a) under the 1940 Act. The "tailored" conditions included in proposed new Rule 12d1-4 are designed to protect shareholders by mitigating potential conflicts of interest and risks related to FOFs, including excessive fees. They address:

- *Control:* Unless the acquiring and acquired funds are members of the same group of investment companies, an acquiring fund and its advisory group could not control an acquired fund. Acquiring funds outside the acquired fund's group of investment companies would only be able to own up to 25% of the acquired fund's shares. A "group of investment companies" continues to be defined as funds which "hold themselves out to investors as related companies for purposes of investment and investor services." An "advisory group" includes an acquiring fund's investment adviser (or subadviser) and persons controlling, controlled by or under common control with the adviser (or subadviser).
- *Voting:* Acquiring funds would be required to either use "pass-through voting" (voting proxies as directed by shareholders of the acquiring fund) or "mirror voting" (voting its shares in proportion with other shareholders of the acquired fund).
- *Redemptions:* An acquiring fund that acquires more than 3% of an acquired fund's outstanding shares would be prohibited from redeeming more than 3% of the acquired fund's outstanding shares in any 30-day period.
- *Duplicative and Excessive Fees:* An investment adviser of an open or closed-end fund or a UIT that is an acquiring fund would be required to determine it to be in the fund's best interest to invest in an acquired fund and to document in writing and (except for a UIT) submit to the acquiring fund's board an evaluation of the complexity of the FOF structure and the aggregate fees associated with the investment in the acquired fund.

- *Disclosure:* Funds would be required to disclose on Form N-CEN that they are or could be an acquiring fund. The Proposal contains related amendments to Form N-CEN. Funds that operate in compliance with Section 12(d)(1)(E) or that limit their investment to money market funds or other specified funds or fund securities would not need to make this disclosure.
- *Complex Structures:* An acquiring fund could not invest in a fund which discloses that it may be an acquiring fund. This effectively prevents an acquired fund from also being an acquiring fund, and thus limits FOF structures to two tiers except in limited circumstances. For instance, a three-tier structure could be permissible where an acquiring fund holds under 3% of an acquiring fund's voting securities.

The Proposals also include amendments to existing Rule 12d1-1 allowing FOFs investing within the same group of investment companies to invest in unaffiliated money market funds.

Out with the Old?

The SEC would rescind Rule 12d1-2, which most FOFs investing within the same group of investment companies under Section12(d)(1)(G) rely upon, and most existing exemptive orders under Sections 12(d)(1)(A), (B), (C), and (G). As the conditions of Rule 12d1-4 differ substantially from Rule 12d1-2 and most exemptive orders, managers of existing FOFs should compare their current compliance procedures to the conditions of the Proposals. If the Proposals could seriously disrupt an FOF's operations, it may be worthwhile to comment on the Proposals. Managers planning to use an FOF structure for new products should also consider whether the Proposals would be compatible with their plans. As is typical, the SEC will be accepting comments on the Proposals for ninety days after they are published in the Federal Register. This post was updated on 4/16/2019.

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