New Fund-of-Funds Rule Should Facilitate Product Development

By Daniel Holtzer*

On October 7, 2020, the U.S. Securities and Exchange Commission (the “SEC”) adopted new fund-of-funds rules that will allow more products to come to market without obtaining an SEC exemptive order. New Rule 12d1-4 allows registered investment companies (open-end fund, ETF, UIT or closed-end fund, collectively, “Funds”) and business development companies (“BDCs”) to acquire securities of other funds or BDCs in excess of limits currently permitted under Section 12 of the Investment Company Act. Unfortunately, the SEC has decided to terminate all prior exemptive orders, thereby handicapping certain legacy products.

Prior to the adoption of Rule 12d1-4, fund-of-fund arrangements were subject to a variety of statutory exemptions, SEC rules, and exemptive orders. These exemptive orders could vary widely in their specific requirements. While a loss for those with favorable exemption terms, clear and uniform rules will mean a more streamlined and predictable process for those looking to build new fund-of-fund structures. To replace this patchwork regulatory approach, the SEC is rescinding Rule 12d1-2 under the 1940 Act, certain Section 12(d)(1) no-action letters, and individual exemptive orders permitting fund-of-funds arrangements that are within the scope of Rule 12d1-4. In light of the rescission of Rule 12d1-2, the SEC amended Rule 12d1-1 under the 1940 Act to allow funds of funds that rely on Section 12(d)(1)(G) to invest in unaffiliated money market funds.

Rule 12d1-4 balances between setting hard limits and allowing funds to negotiate terms that best suit their situations with respect to fund-of-fund arrangements. Rule 12d1-4 restricts the complexity of fund structures by limiting acquired fund’s investments in other funds as well as eliminating voting control by setting voting rules. To protect consumers, the SEC has adopted rules to prevent fee duplication. Yet important aspects of Fund-of-Fund arrangements, such as redemption limits, are left up to fund managers to set in negotiations.

Since the SEC did not set bright-line redemption limit rules, this will likely be a key aspect of fund-of-fund agreement negotiations. Rule 12d1-4 requires investment advisers of acquired funds to make several findings before an agreement can be reached. These findings focus the adviser on sources of undue influence from the acquired fund, particularly redemption limits and notice of redemption. Managers of funds should take advantage of the lack of hard limits to negotiate favorable terms, but ensure that the negotiated terms do not create undue influence.

Voting and control remain key issues for the SEC. The voting guidelines are tailored to reduce the power of the acquiring funds and to prevent activist Fund-of-Fund arrangements. The SEC has made it very clear in this rule that Fund-of-Fund relationships will not be a way for acquiring funds to gain control of acquired funds. Fund managers should pay close attention to the voting requirements that Fund-of-Fund relationships create and ensure that they comply with these rules.

Fund-of-Fund Agreements
Rule 12d1-4 replaces the prior participation agreement concept with a “Fund-of-Funds Investment Agreement” that must be entered into before an acquiring fund acquires securities of an acquired fund in excess of Section 12 limits, unless both funds have the same adviser. Fund-of-fund (“Fund-of-Fund”) agreements are required to include terms relating to disclosure of information that each firm needs to meet its compliance obligations, such as acquiring fund fee and expense information.

In order to enter a fund-of-fund arrangement, the investment adviser of the acquired fund must make a finding that there isn’t undue influence present in the fund-of-fund structure. There are several factors that the investment adviser of the acquired fund must consider:

- 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.

An acquiring fund’s investment adviser must also determine that the acquiring fund’s fees and expenses do not duplicate the fees and expenses of the acquired fund, based on an evaluation of the complexity of the structure and the fees and expenses associated with the acquiring fund’s investment in the acquired fund. Further, the investment adviser to an acquiring fund will be required to report on its evaluation and finding to the board of directors of the acquiring fund.

It is up to the adviser to ensure that the terms present in the fund-of-fund agreement do not present issues of undue influence, particularly with respect to the factors in Rule 12d1-4.

**Voting and Control**

Rule 12d1-4 requires that acquiring funds perform mirror voting in two circumstances. The first is if an acquiring fund owns 25% or more of voting securities of an open-end fund. The second is if an acquiring fund holds 10% or more of voting securities of a closed-end fund or BDC. If, however, the acquiring fund is the only holder of voting securities of the acquired fund, they may use pass-through voting. These voting requirements do not apply to an acquiring fund: (1) in the same fund group as the acquired fund; or (2) with a sub-adviser that also acts as adviser to the acquired fund.

Prior to the adoption of Rule 12d1-4, many exemptive orders required either pass-through or mirror voting if more than 3% of voting securities were held. Rule 12d-14 is more permissive in that it raised the share limits, but more restrictive in that it does not give the choice between mirror and pass-through voting.

**Multi-Tiered Structures**

Rule 12d1-4 allows a registered fund to invest 10% of its assets in other funds, including private funds, subject to certain exceptions for master-feeder funds or money market fund investments. Acquired funds seeking to invest beyond 10% of their assets in underlying funds must still seek exemptive relief. When managing complex structures, fund managers must make a more thorough analysis of the fee structure to prevent fee duplication. Many existing multi-tier structures may need to be restructured.

**Duplication of Fees**
The SEC is concerned that more complex structures and even two-tiered fund-of-fund structures may result in duplicative fees for investors. To prevent this, careful review is required by the acquiring fund manager to ensure that fees are not repeated in different fund layers. Disclosure of fee information from the acquired fund to the acquiring fund is required so that this review can be meaningfully conducted.

Amendments to Form N-CEN and Form N-1A

The SEC is also amending Form N-CEN to require funds and UITs to report whether they relied on Rule 12d1-4 or the statutory exception in Section 12(d)(1)(G) of the 1940 Act. In addition, open-end funds that invest 10% or less of their total assets in acquired funds may omit Acquired Fund Fees and Expenses from their bottom-line expenses in Form N-1A fee tables and disclose this amount in a footnote to the table instead.

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