

SEC Updates Regulatory Framework for Fund of Funds Arrangements, but Private Funds Remain Subject to Limits on Purchases of Investment Company Shares

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What You Need To Know:

- The SEC's updates to the regulatory framework for fund of funds arrangements will be helpful to registered investment companies.
- Private funds will not be afforded additional flexibility to invest in registered investment companies under the harmonized regime.
- Private funds should be aware of the prescribed limitation set forth under section 12(d)(1) and implement policies and procedures to monitor and ensure that they do not exceed the limit. Registered investment companies should also adjust their compliance programs to account for the SEC's updated regulatory framework.

On October 7, 2020, the Securities and Exchange Commission (SEC) voted to adopt rule 12d1-4 under the Investment Company Act of 1940 (the 1940 Act) and related amendments to streamline and enhance the regulatory framework, which governs registered funds that invest in other investment companies and private funds¹ that invest in other registered funds ("fund of funds" arrangements). The SEC is also rescinding rule 12d1-2 and most exemptive orders granting relief from sections 12(d)(1)(A), (B), (C), and (G) of the 1940 Act and adopting related amendments to rule 12d1-1 under the 1940 Act and Form N-CEN.

I. Current Regulatory Framework

Section 12(d)(1) of the 1940 Act limits a registered fund's investments in other

investment companies and a private fund's investments in registered funds. Section 12(d)(1)(A) proscribes a registered fund (and companies, including funds, it controls) (the "acquiring fund") from acquiring more than 3 percent of another investment company's (the "acquired fund") outstanding voting securities, investing more than 5 percent of its total assets in any one acquired fund, or investing more than 10 percent of its total assets in an acquired fund and other investment companies generally.

These limits apply to both registered and unregistered investment companies with respect to their investments in a registered investment company. These limitations also apply to registered investment companies' investments in unregistered investment companies. Under sections 3(c)(1) and 3(c)(7)

¹ A "private fund" is an issuer that would be an investment company, as defined in section 3 of the 1940 Act, but for section 3(c)(1) or 3(c)(7) of the 1940 Act. 15 U.S.C. 80b-2(a)(29).

of the 1940 Act, private funds are subject to a 3 percent limitation on investments in registered funds.

Numerous statutory exemptions, SEC rules, and exemptive orders have been issued and adopted over time in response to the development of fund of funds structures. As a result, the regulatory regime has evolved to one where substantially similar fund of funds arrangements are subject to different conditions. By voting to adopt rule 12d1-4 and other related amendments, the SEC is seeking to create a consistent and efficient rules-based regulatory regime for fund of funds arrangements.

II. Updated Regulatory Framework: Summary of New Rule and Related Amendments

A. Rule 12d1-4

Rule 12d1-4 will permit registered investment companies or business development companies to acquire securities of any other registered investment company or business development company in excess of the limits prescribed in section 12(d)(1) of the 1940 Act, subject to certain conditions, without obtaining an individual exemptive order from the SEC. The conditions include (i) limits on the control and influence an acquiring fund can exert on the acquired fund, (ii) limits on certain fees charged to the acquiring fund and its shareholders, and (iii) limits on the acquired fund's ability to invest in other investment companies and private funds. Consequently, open-end funds (including exchange-traded funds), unit investment trusts (including exchange-traded funds organized as unit investment trusts), and closed-end funds (including business development companies) will be able to rely on this rule as both acquiring and acquired funds. Notably, private funds and foreign funds will not be able to rely on rule 12d1-4.

The rule will also provide an exemption from section 17(a)² of the 1940 Act as well as a limited exemption from that section for in-kind transactions for certain affiliated persons of exchange-traded funds.³

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

The SEC is rescinding rule 12d1-2, which permits acquiring funds that primarily invest in affiliated funds, in reliance on section 12(d)(1)(G), to invest in unaffiliated funds and non-fund assets. The SEC is also rescinding the exemptive orders, which permit fund of funds arrangements, except with respect to relief related to interfund lending arrangements. Consequently, acquiring funds will be required to rely on rule 12d1-4 (and comply with its related conditions) in order to establish certain fund of funds arrangements that exceed the statutory limitations.

Furthermore, the SEC is amending rule 12d1-1 to permit acquiring funds that rely on section 12(d)(1)(G) (to primarily invest in affiliated funds) to continue to invest in unaffiliated money market funds.

C. Amendments to Form N-CEN

The SEC is amending Form N-CEN to require registered funds to report whether they relied on rule 12d1-4 or section 12(d)(1)(G) of the 1940 Act, the statutory exception, during the applicable reporting period.

III. Implications for Private Funds

The rule will not allow private funds and unregistered investment companies to rely on rule 12d1-4 as acquiring funds. As noted above, private funds and unregistered investment companies remain subject to the 3 percent limitation on investments in registered funds under sections 3(c)(1) and 3(c)(7) of the 1940 Act.

The SEC believes that the exemptive application process is the appropriate channel for specific applicants that seek relief to permit private funds or unregistered investment companies to invest in registered funds beyond the limits set forth in section 12(d)(1) of the 1940 Act. This is namely because private funds and unregistered investment companies are not registered with the SEC, and therefore their investments in registered funds are not subject to (i) governance and compliance requirements

² A fund that holds 5% or more of the acquired fund's securities would be prohibited from making any additional investments in the acquired fund under section 17(a) of the 1940 Act.

³ Section 17(a) of the 1940 Act would otherwise "prohibit the delivery or deposit of basket assets on an in-kind basis by certain affiliated funds (that is, by exchanging certain assets from the exchange-traded fund's portfolio, rather than in cash)."

and (ii) reporting requirements under the 1940 Act. These requirements are essential to the oversight and monitoring provisions of rule 12d1-4 for registered funds.

To date, the SEC has not extended exemptive relief permitting private funds to acquire other investment companies in excess of the section 12(d)(1) limits. Use of the exemptive application process will provide the SEC with experience as it relates to this type of fund of funds arrangement. The SEC will also be able to monitor fund of funds arrangements that operate pursuant to such exemptive relief.

IV. Next Steps and Takeaways

The SEC's updates to the regulatory framework for fund of funds arrangements will be helpful to registered investment companies. Private funds, however, will not be afforded additional flexibility to invest in registered investment companies under the harmonized regime.

As such, private funds should be aware of the prescribed limitation set forth under section 12(d)(1) and implement policies and procedures to monitor and ensure that they do not exceed the limit. Registered investment companies should also adjust their compliance programs to account for the SEC's updated regulatory framework.

Rule 12d1-4 will be effective 60 days after publication in the Federal Register. The compliance date for the amendments to Form N-CEN will be 425 days after publication in the Federal Register. The rescission of rule 12d1-2 and the SEC's existing exemptive orders will continue to be effective one year after the effective date of rule 12d1-4.

Please contact one of the listed authors of this Alert or your regular Lowenstein Sandler contact if you have any questions regarding the SEC's new rule and related amendments or would like assistance adjusting your compliance policies and procedures with respect to the updated regulatory regime.

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