SEC ADOPTS NEW RULE 12D1-4 OVERHAULING FUND OF FUNDS ARRANGEMENTS--ARE YOU READY?

Date: 26 October 2020

Asset Management and Investment Funds Alert

By: Jon-Luc Dupuy, Mark P. Goshko, Fatima S. Sulaiman, Abigail P. Hemnes, Jennifer R. Gonzalez, Jordan A. Knight, George Zornada

Sections:

Executive Summary

Rule 12d1-4

Limits on Control and Voting Requirements

Required Evaluations, Findings and Reports

Fund of Funds Investment Agreements

Limits on Complex Structures and the Ten Percent Bucket

Exemption from Section 17(a) of the 1940 Act for Fund of Funds Arrangements

Recordkeeping

Changes from the Current Regulatory Regime

Rescission of Rule 12d1-2 and Exemptive Relief; Withdrawal of Staff Letters

Conditions of Rule 12d1-4 Compared to Conditions of Prior Exemptive Orders

Ancillary Changes

Amendments to Rule 12d1-1

Updates to Form N-CEN

I. EXECUTIVE SUMMARY

On 7 October 2020, the Securities and Exchange Commission (the SEC) adopted new rule 12d1-4 (Rule 12d1-4) and related amendments under the Investment Company Act of 1940 (the 1940 Act) that it believes will streamline and enhance the regulatory framework applicable to fund of funds arrangements.

Importantly, Rule 12d1-4:

- *will* permit a fund to acquire the securities of another fund in excess of the limits imposed by Section 12 of the 1940 Act without obtaining an exemptive order from the SEC, subject to certain conditions;

©2005-2026 K&L Gates LLP. All Rights Reserved.

- *will* allow open-end funds, unit investment trusts (UITs), closed-end funds, business development companies (BDCs), exchange-traded funds (ETFs), and exchange-traded managed funds (ETMFs) all to act as both acquiring and acquired funds[1]; and
- *does not* expand the ability of private funds and unregistered investment companies, such as foreign funds, to invest in registered investment companies.[2]

In a welcome departure from the SEC's 2018 proposal, Rule 12d1-4 *does not* include a provision limiting redemptions by an acquiring fund to no more than 3 percent of an acquired fund's shares in any 30-day period.

Rule 12d1-4 is intended to create a more comprehensive and consistent framework for fund of funds arrangements to replace the existing approach, which combines statutory exemptions, SEC rules, and exemptive orders and varies based on an acquiring fund's type. Accordingly, as proposed, the SEC is rescinding Rule 12d1-2 under the 1940 Act and most exemptive orders for fund of funds arrangements, as well as related no-action letters. While Rule 12d1-4 will permit more types of fund of funds arrangements without an exemptive order, it imposes a new set of conditions including limits on control and voting of acquired funds' shares, evaluations and findings by investment advisers, fund investment agreements, and limits on most three-tier fund structures. These conditions overlap to some extent with prior exemptive orders. However, advisers with existing fund of funds arrangements will need to evaluate operational and procedural changes necessary to comply with Rule 12d1-4 and may need to restructure fund investments.

Choose, Does your FoF Make Direct Investments? For example, funds that invest in other funds in the "same group of investment companies" currently may rely on Section 12(d)(1)(G) of the 1940 Act in combination with Rule 12d1-2 to invest in outside funds and stocks, bonds, and other securities. With the rescission of Rule 12d1-2, these funds must *either* comply with Rule 12d1-4's new conditions to maintain this flexibility or else limit their investments only to those permitted by Section 12(d)(1)(G)—funds in the same group, U.S. government securities, and short-term paper—as well as outside money market funds as permitted by amended Rule 12d1-1 (as amended by this SEC rulemaking).

Multi-Tiered Fund Structures Largely Eliminated. In addition, Rule 12d1-4's restrictions on multi-tier fund of funds arrangements, and the rescission of exemptive orders permitting these arrangements, will result in the elimination of many of these arrangements. Rule 12d1-4 permits an acquired fund in a fund of funds arrangement to invest in securities of investment companies or private funds in an amount not to exceed 10 percent of the acquired fund's total assets, subject to certain limited exceptions, such as master-feeder arrangements or money market fund investments. A fund that invests in other funds beyond this "10 Percent Bucket" (as defined below) may not be an acquired fund under Section 12(d)(1)(G) or Rule 12d1-4. Thus, current fund of funds arrangements in which an acquired fund relies on an ETF or fund of funds exemptive order to invest more than 10 percent of its total assets in other funds may need to be restructured.

The SEC also adopted related amendments to Rule 12d1-1 to preserve the ability of funds that rely on Section 12(d)(1)(G) to invest in money market funds that are not part of the same fund group. The SEC amended Form N-CEN to require open-end funds, closed-end funds, and UITs to report whether they relied on Section 12(d)(1)(G) or Rule 12d1-4 during the reporting period.

Rule 12d1-4 will be effective 60 days after publication in the Federal Register.[3] The compliance date for the amendments to Form N-CEN will be 425 days after publication in the Federal Register. The rescission of Rule

©2005-2026 K&L Gates LLP. All Rights Reserved.

12d1-2 and exemptive orders deemed to "fall within the scope of Rule 12d1-4," as well as the withdrawal of no-action letters applicable to specific circumstances related to Section 12(d)(1), will be effective one year after the effective date of Rule 12d1-4.

Background and Current Regulatory Framework

Section 12(d)(1)(A) prohibits a registered investment company from acquiring shares of an investment company if immediately after such purchase the acquiring fund would own more than 3 percent of the total outstanding voting stock of the acquired company, or more than 5 percent of the acquiring fund's assets would be invested in the acquired fund, or more than 10 percent of the acquiring fund's assets would be invested in other investment companies in the aggregate. These are commonly referred to as the "3/5/10 Limits." Section 12(d)(1)(B) places parallel prohibitions on the sales of shares by open-end acquired funds. These restrictions were enacted to prevent "pyramiding," excessive fees, and the formation of overly complex structures. As a result of evolving views on fund of funds arrangements, Congress created statutory exceptions and the SEC adopted rules that permitted different types of fund of funds arrangements subject to certain conditions, and the SEC has further provided exemptive relief for fund of funds arrangements subject to various conditions. On 19 December 2018, the SEC proposed Rule 12d1-4 to provide a comprehensive exemption for fund of funds arrangements. The SEC received feedback from a wide range of commenters. While Rule 12d1-4 was adopted largely as proposed, several changes were made to controversial provisions in the proposal in light of industry concerns. For example, the SEC chose not to adopt a proposal to limit redemptions by an acquiring fund to no more than 3 percent of an acquired fund's shares in a 30-day period.

II. RULE 12D1-4

Rule 12d1-4 will allow any registered investment company (open-end fund, ETF, UIT, or closed-end fund) or BDC (referred to collectively as acquiring funds) to acquire securities of any other registered investment company or BDC (referred to collectively as acquired funds) in excess of the 3/5/10 Limits, subject to the following conditions.

a. Limits on Control and Voting Requirements

i. Control Limits

> Mirror voting is generally required when funds hold a control position in funds outside the same group of investment companies.

Rule 12d1-4 will prohibit an acquiring fund and its "advisory group" from controlling, individually or in the aggregate, an acquired fund, except for 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.[4] Rule 12d1-4 requires an acquiring fund to aggregate its investment in an acquired fund with the investment of the acquiring fund's advisory group to assess control. The 1940 Act creates a rebuttable presumption that any person who, directly or indirectly, beneficially owns more than 25 percent of the voting securities of a company controls the company and that any person who does not own that amount does not control it. Accordingly, an acquiring fund and its advisory group's individual or

©2005-2026 K&L Gates LLP. All Rights Reserved.

aggregate beneficial ownership of up to 25 percent of the voting securities of an acquired fund will be presumed not to constitute control over the acquired fund. This restriction does not vary based on the type of acquired fund.

ii. Voting Requirements

Rule 12d1-4 requires an acquiring fund and its advisory group to mirror vote shares held in an acquired fund (that is, cast votes in the same proportion as the other holders of the acquired fund) if ownership of the acquired fund exceeds certain thresholds. The 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. Rule 12d1-4 imposes different thresholds for mirror voting depending on the type of acquired fund. An acquiring fund and its advisory group must use mirror voting if they hold more than 25 percent of the voting securities of an acquired fund that is an open-end fund or UIT due to a decrease in the outstanding securities of the acquired fund. If the acquired fund is a closed-end fund or BDC, the acquiring fund and its advisory group must use mirror voting if they hold more than 10 percent of the voting securities of the acquired closed-end fund or BDC.

Rule 12d1-4 requires an acquiring fund and its advisory group to instead use pass-through voting (that is, seek voting instructions from the acquiring fund's own shareholders and vote accordingly) in situations where all holders of an acquired fund's outstanding voting securities are required by Rule 12d1-4 or Section 12(d)(1) of the 1940 Act to use mirror voting. The SEC Release provides that in circumstances where mirror voting by an acquiring fund simply would not be possible, such as when acquiring funds are the only shareholders of an acquired fund, the acquiring fund must use pass-through voting.

iii. Exceptions to Control and Voting Conditions

Rule 12d1-4 contains two exceptions from the control and voting conditions. The control and voting conditions do not apply when: (1) an acquiring fund is within the same group of investment companies as an acquired fund; or (2) 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 (i.e., sub-adviser proprietary funds). The SEC defines the term “group of investment companies” as “any two or more registered investment companies or business development companies that hold themselves out to investors as related companies for investment and investor services.”[5] The exceptions are designed to include arrangements that are permissible under Section 12(d)(1)(G) of the 1940 Act and prior exemptive orders.

b. Required Evaluations, Findings, and Reports

> Advisers will generally be required to consider specific factors and make specific findings prior to investment to ensure that undue influence concerns associated with the acquiring fund’s investment in the acquired fund are reasonably addressed and fees and expenses are not duplicative.

i. Management Companies

Rule 12d1-4 requires an adviser to a management company (an open-end fund or closed-end fund, including a BDC) operating in accordance with Rule 12d1-4 to evaluate and make certain findings regarding the arrangement. For management companies that are *acquired* funds, Rule 12d1-4 requires the acquired fund's adviser to find that any undue influence concerns associated with the acquiring fund's investment in the acquired

©2005-2026 K&L Gates LLP. All Rights Reserved.

fund are reasonably addressed, after considering, at a minimum, enumerated factors regarding: (1) any maximum limits on the acquiring fund's investment; (2) the timing of the acquiring fund's redemption requests and whether it will provide advance notice of investments and redemptions; and (3) whether and under what terms the acquired fund may redeem in kind. Where the *acquiring* fund is a management company, Rule 12d1-4 requires the acquiring fund's adviser to evaluate the complexity of the structure associated with the acquiring fund's investment in the acquired fund. The acquiring fund's adviser also must evaluate the relevant fees and expenses and find that the acquiring fund's fees and expenses do not duplicate the fees and expenses of the acquired fund. Because concerns regarding duplicative fees and complexity of structure are relevant for an acquiring fund, only the adviser to an acquiring fund will need to evaluate and make findings related to these concerns. For both acquiring 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.

The investment adviser to each acquired fund or acquiring fund must report its evaluation and findings, and the basis for its evaluation and findings, to the fund's board of directors no later than the next regularly scheduled board meeting. Subsequent reporting of the adviser's evaluation and findings will be conducted at least annually under such fund's compliance program.

ii. Unit Investment Trusts

Rule 12d1-4 requires tailored findings regarding acquiring UITs. 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. Rule 12d1-4 also requires the principal underwriter or depositor to base its finding on an evaluation of the complexity of the structure and the aggregate fees and expenses associated with the UIT's investment in acquired funds.

iii. Separate Accounts Funding Variable Insurance Contracts

With respect to a separate account funding variable insurance contracts that invests in an acquiring fund, Rule 12d1-4 requires 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 consistent with the standard set forth in Section 26(f)(2)(A) of the 1940 Act. This standard provides that the fees must be reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurance company.

c. Fund of Funds Investment Agreements

> In lieu of the proposed 3 percent limitation on redemptions, funds that do not share the same investment adviser will be required to enter into a Fund of Funds Investment Agreement memorializing the terms of the arrangement.

Rule 12d1-4 incorporates a modified version of the concept of participation agreements between otherwise unrelated acquiring and acquired funds. Rule 12d1-4 requires funds to enter into a “Fund of Funds Investment Agreement” before an acquiring fund acquires securities of an acquired fund in excess of the limits of Section

©2005-2026 K&L Gates LLP. All Rights Reserved.

12(d)(1) of the 1940 Act in reliance on Rule 12d1-4, unless both funds have the same adviser.[6] The Fund of Funds Investment Agreement, which was not part of the original rule proposal, must include the following: (1) any material terms necessary for the adviser, underwriter, or depositor to make the required fund findings where the funds involved include management companies or UITs; (2) a termination provision permitting either the acquiring or acquired fund to terminate the agreement upon no more than 60 days' written notice; and (3) a requirement that the acquired fund provide the acquiring fund with information on the fees and expenses of the acquired fund reasonably requested by the acquiring fund. The SEC Release provides that in negotiating a Fund of Funds Investment Agreement, the funds could set the terms of the agreement that support the required fund findings discussed above. Specifically, "an acquired fund could require the acquiring fund to agree to submit redemptions over a certain amount for a given period as a condition to the fund of funds investment agreement." Finally, the SEC noted that Fund of Funds Investment Agreements are material contracts not made in the ordinary course of business and, therefore, must be filed as an exhibit to each fund's registration statement.

The SEC believes that Fund of Funds Investment Agreements differ in certain ways from participation agreements required under most of the SEC's fund of funds exemptive orders. Participation agreements under such orders require both funds in a fund of funds arrangement (and their investment advisers) to fulfill their responsibilities under the order and, as such, participation agreements can vary. Participation agreements also require that the acquiring fund notify the acquired fund prior to investing in excess of the limits of Section 12(d)(1)(A) and provide the acquired fund a list of the names of each of its affiliates to help the acquired fund ensure compliance with the affiliated transaction provisions of the 1940 Act. However, because all funds operating in accordance with Rule 12d1-4 will be required to comply with its conditions, the SEC determined that Rule 12d1-4 will not require that a Fund of Funds Investment Agreement include these types of contractual provisions. Instead, a Fund of Funds Investment Agreement will be required to memorialize the terms of the arrangement that serve as a basis for the required fund findings described above. The SEC believes this approach may enable funds to tailor various terms of a Fund of Funds Investment Agreement to their specific arrangements and thereby provide greater protection against undue influence.

The efficacy and enforceability of the provisions of Fund of Funds Investment Agreements remains an open question, however. For example, while Rule 12d1-4 at least contemplates that a Fund of Funds Investment Agreement may require advance notice of redemptions and impose a redemption limit, it does not indicate whether or how such limits would be enforceable. Indeed, for acquired funds that are listed on an exchange or are sold primarily through intermediaries using omnibus accounts, it is unclear whether the acquired funds would always know if an acquiring fund planned to or had invested in excess of Section 12(d)(1)(A) limits or be able to prevent such excess purchases even if known.[7] This issue may also have implications for the acquiring fund's and acquired fund's respective liquidity risk management programs adopted under Rule 22e-4 under the 1940 Act.

d. Limits on Complex Structures and the Ten Percent Bucket

> To limit overly complex structures, funds will generally be limited to two tiers. However, Rule 12d1-4 allows for a fairly flexible 10 percent allocation by acquired funds to investments in other funds (in addition to investments in money market funds pursuant to Rule 12d1-1).

©2005-2026 K&L Gates LLP. All Rights Reserved.

Rule 12d1-4 is designed to restrict fund of funds arrangements to two tiers, except in limited circumstances. Rule 12d1-4 does permit some multi-tier structures, but generally prohibits an acquiring fund (relying on Section 12(d)(1)(G) or Rule 12d1-4) from investing in an acquired fund that in turn relies on Rule 12d1-4 to invest in other funds. An acquired fund is permitted, however, to invest in other investment companies and private funds if, immediately after such purchase, the aggregate value of such investment company and private fund securities does not exceed 10 percent of the acquired fund's total assets (the 10 Percent Bucket).[8] These second and third-tier arrangements would be subject to the conditions of Rule 12d1-4 if the acquired fund's investment in an underlying fund is outside of the 3/5/10 Limits. The following investments are excluded from the 10 Percent Bucket: (1) investments that are part of a master-feeder structure in reliance on Section 12(d)(1)(E) of the 1940 Act; (2) investments in money market funds in reliance on Rule 12d1-1 (as amended); (3) investments in a wholly owned and controlled subsidiary of the acquired fund; (4) securities received as a dividend or because of a company reorganization; and (5) securities received pursuant to an interfund lending arrangement permitted by an SEC exemptive order.

The 10 Percent Bucket for acquired funds provides a degree of flexibility for an acquired fund to invest up to 10 percent of its total assets in other funds without restriction on the purpose of the investment or types of underlying funds, or the size of the investment in a particular underlying fund, and to invest in accordance with the exclusions described above. However, this condition is more limiting than those in the SEC's exemptive orders, and the SEC Release notes that some existing multi-tier structures may need to change their investments to comply with Rule 12d1-4.

e. Exemption From Section 17(a) of the 1940 Act for Fund of Funds Arrangements

As proposed, Rule 12d1-4 provides an exemption from Section 17(a) of the 1940 Act with respect to fund of funds arrangements. Section 17(a) generally prohibits an affiliated person of a fund, or any affiliated person of such person, from selling any security or other property to, or purchasing any security or other property from, the fund. The 1940 Act generally defines an “affiliated person” of a fund to include someone owning, controlling, or having the power to vote, 5 percent or more of a fund's outstanding voting securities. The SEC Release states that “[a]bsent an exemption, [S]ection 17(a) would prohibit a fund that holds 5% or more of the acquired fund's securities from making any additional investments in the acquired fund, limiting the efficacy of [R]ule 12d1-4.” Rule 12d1-4 provides a limited exemption from Section 17(a) for in-kind transactions with certain affiliated persons of ETFs. Rule 12d1-4 permits an acquiring fund that is an affiliated person of an ETF (or an affiliated person of such an acquiring fund) solely by reason of holding with the power to vote 5 percent or more of the outstanding shares of: (i) the ETF; or (ii) any fund that is an affiliated person of the ETF, to deposit and receive the ETF's “baskets,”[9] provided that the acquired ETF is not otherwise an affiliated person (or affiliated person of an affiliated person) of the acquiring fund. Thus, an acquiring fund may transact with an ETF through an authorized participant that holds 5 percent or more of the ETF.

f. Recordkeeping

Rule 12d1-4 requires the acquiring and acquired funds that participate in fund of funds arrangements in accordance with Rule 12d1-4 to maintain and preserve certain written records, as enumerated in Appendix A, for a period of not less than five years, the first two years in an easily accessible place.

©2005-2026 K&L Gates LLP. All Rights Reserved.

III. CHANGES FROM THE CURRENT REGULATORY REGIME

a. Rescission of Rule 12d1-2 and Exemptive Relief; Withdrawal of Staff Letters

The SEC is rescinding Rule 12d1-2 under the 1940 Act and individual exemptive orders permitting fund of funds arrangements that fall within the scope of Rule 12d1-4 that have been granted pursuant to Sections 12(d)(1)(A), (B), (C), and (G) of the 1940 Act.[10] The SEC is not rescinding exemptive relief granted to funds of funds that is outside the scope of Rule 12d1-4.[11] The SEC is also withdrawing no-action letters applicable to specific circumstances related to Section 12(d)(1). The rescission of Rule 12d1-2 will eliminate the flexibility of funds relying on Section 12(d)(1)(G) to: (i) acquire the securities of other funds that are not part of the same group of investment companies, subject to the limits in Section 12(d)(1)(A) or 12(d)(1)(F); and (ii) invest directly in stocks, bonds, and other securities. Practically, this may have significant implications for affiliated fund of fund structures. Going forward, these types of funds of funds will be required either to rely on Rule 12d1-4 and the applicable conditions (i.e., the conditions relating to findings and board reporting) or to comply with the restrictive requirements of Section 12(d)(1)(G). Funds choosing to rely on Section 12(d)(1)(G) will lose the ability to acquire securities of funds outside of the fund group (except money market funds) and invest directly in stocks, bonds and other securities (in reliance on Rule 12d1-2), and derivatives and other financial instruments that are not securities under the 1940 Act (as now permitted under the Northern Lights Fund Trust no-action letter[12]).

In order to "limit the hardship that the rescission of Rule 12d1-2 could have on existing fund of funds arrangements," the SEC is adopting a one-year period after the effective date before Rule 12d1-2 is rescinded.

The rescission of fund of funds exemptive orders may require complexes that currently employ a multi-tier structure by relying on a combination of Section 12(d)(1)(G) and Rule 12d1-2, and either an ETF or fund of funds exemptive order, to restructure their investments.

b. Conditions of Rule 12d1-4 Compared to Conditions of Prior Exemptive Orders

As discussed above, the conditions of Rule 12d1-4 are largely based on the conditions in prior fund of funds exemptive orders. However, Rule 12d1-4 also contains notable differences from prior exemptive orders and the current regulatory framework for fund of funds arrangements, which are described in more detail below and in Appendix A.

i. Limits on Control and Voting

Rule 12d1-4's conditions limiting control by acquiring funds and imposing voting requirements when an acquiring fund's ownership of an acquired fund exceeds certain thresholds are generally consistent with the conditions in prior exemptive relief. Accordingly, funds relying on prior exemptive orders likely already have established policies and procedures to monitor compliance with the aggregation requirement embedded in the definition of the term "advisory group."[13] However, to the extent that an advisory group has not already established policies and procedures pursuant to an exemptive order, the advisory group may need to restructure information barriers to permit entities within the advisory group to share the necessary information to comply with Rule 12d1-4.

Similar to prior exemptive orders, Rule 12d1-4 imposes different ownership thresholds for triggering mirror voting based on the type of acquired fund. Rule 12d1-4 requires an acquiring fund and its advisory group to use mirror voting if they hold more than 25 percent of the voting securities of an acquired open-end fund or UIT due to a decrease in number of those shares outstanding, or more than 10 percent of the voting securities of an acquired

©2005-2026 K&L Gates LLP. All Rights Reserved.

closed-end fund or BDC. In contrast, prior exemptive orders required mirror voting for acquired closed-end funds once the acquiring fund's and its advisory group's ownership exceeded 3 percent.

ii. Required Evaluations and Findings

Rule 12d1-4 imposes new requirements for an acquiring fund's adviser, principal underwriter, or depositor to make certain evaluations and findings and report such findings to the board, as discussed above and in Appendix A. Rule 12d1-4 also requires an acquired fund's adviser to make certain findings.

Rule 12d1-4 eliminates prior exemptive order conditions that require findings on behalf of an acquiring fund board, as many of the conditions relating to fee limitations are redundant in light of a fund adviser's and board's fiduciary duties and statutory obligations, including Section 15 obligations. However, an acquiring fund board must review the adviser's findings regarding the fund of funds arrangement, which is an additional responsibility.

iii. Required Fund of Funds Investment Agreements

The Fund of Funds Investment Agreement differs in certain ways from the participation agreements required in prior exemptive orders. For example, in contrast to a participation agreement, the Fund of Funds Investment Agreement will be required to memorialize the terms of the arrangement that serve as a basis for the findings required by Rule 12d1-4. In addition, many of the provisions in current participation agreements that are required by, or supportive of, conditions in fund of fund exemptive orders will no longer be applicable. Practically, this will mean that fund of fund arrangements between funds that do not have the same investment adviser will need to be reviewed and, ultimately, a Fund of Funds Investment Agreement will need to be put into place for these arrangements.

iv. Limits on Complex Structures

The conditions in Rule 12d1-4 restricting fund of funds arrangements to two tiers, other than in limited circumstances, are generally more comprehensive and, therefore, more limiting than the conditions in prior exemptive orders. Notably, however, Rule 12d1-4 has provided for the 10 percent Bucket, which may provide acquired funds with flexibility to invest in underlying funds. The SEC has also indicated a willingness to consider exemptive relief requests to allow acquired funds to invest beyond the 10 percent limit in other underlying funds.

IV. ANCILLARY CHANGES

a. Amendments to Rule 12d1-1

As proposed, the SEC decided to amend 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. The amendment will provide these funds with continued flexibility to invest in money market funds, including private funds, outside of the same group of investment companies despite the rescission of Rule 12d1-2.

b. Updates to Form N-CEN

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 during the applicable reporting period, as described in more detail in Appendix A.

©2005-2026 K&L Gates LLP. All Rights Reserved.

APPENDIX A

Conditions in Prior Exemptive Orders	Conditions in Rule 12d1-4
Limits on Control and Voting	
An acquiring fund and its advisory group affiliates may not control (*i.e.*, own more than 25 percent) an unaffiliated acquired fund.	*Substantively the same as prior exemptive orders.*
An acquiring fund must aggregate its investment in an acquired fund with the investment of the acquiring fund's "advisory group."	*Substantively the same as prior exemptive orders.*
An acquiring fund and its advisory group must vote their shares using mirror voting if the acquiring fund and its advisory group become holders of more than 25 percent of the voting securities of an open-end fund or UIT due to a decrease in the outstanding securities of the acquired fund.	*Substantively the same as prior exemptive orders.*
An acquiring fund and its advisory group that hold more than 3 percent of the outstanding voting securities of a closed-end fund must use either pass-through or mirror voting, and non-fund entities within the advisory group must use mirror voting.	An acquiring fund and its advisory group that hold more than 10 percent of the outstanding voting securities of a closed-end fund or BDC must use mirror voting.
No comparable condition imposed by prior exemptive orders.	Requires pass-through voting where acquiring funds are the only shareholders of an acquired fund.
Exempts from the control and voting conditions: (1) an acquiring fund that is part of the same fund group as the acquired fund; and (2) an acquiring fund that has a sub-adviser that acts as adviser to the acquired fund.	*Substantively the same as prior exemptive orders.*
Required Evaluations and Findings	
Fund boards must make certain findings regarding the advisory fees (e.g., that they are not duplicative) and adopt procedures to prevent overreaching or undue influence by an acquired fund.	*Eliminated by Rule 12d1-4, however, a board's fiduciary duties and statutory obligations generally require oversight and review of fund of funds arrangements.*
No comparable condition imposed by prior exemptive orders.	The adviser of an acquired management company must: (1) find that any undue influence concerns

©2005-2026 K&L Gates LLP. All Rights Reserved.

Conditions in Prior Exemptive Orders	Conditions in Rule 12d1-4
	associated with the acquiring fund's investment in the acquired fund are reasonably addressed, after considering certain specific factors; and (2) report such evaluation, finding, and basis for its evaluations and findings to the board no later than the next regularly scheduled board meeting. Factors include: (1) the scale of contemplated investments by the acquiring fund and any maximum investment limits; (2) the anticipated timing of redemption requests by the acquiring fund; (3) whether, and under what circumstances, the acquiring fund will provide advance notification of investment and redemptions; and (4) 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.
No comparable condition imposed by prior exemptive orders.	The adviser of an acquiring management company must: (1) evaluate the complexity of the structure associated with the acquiring fund's investment in the acquiring fund and the relevant fees and expenses; (2) find that the acquiring fund's fees and expenses do not duplicate fees and expenses of the acquired fund; and (3) report such evaluation, finding, and basis for its evaluations and findings to the board no later than the next regularly scheduled board meeting.
No comparable condition imposed by prior exemptive orders.	The principal underwriter or depositor of an acquiring UIT must: (1) 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; and (2) base its finding on an evaluation of the complexity of the structure and the aggregate fees and expenses associated with the UIT's investment in acquired funds.
Require an insurance company to certify to the acquiring fund that the aggregate of all fees and	*Similar to prior exemptive orders*. An insurance company sponsoring a separate account must

©2005-2026 K&L Gates LLP. All Rights Reserved.

Conditions in Prior Exemptive Orders	Conditions in Rule 12d1-4
charges associated with each variable insurance contract that invests in the acquiring fund are reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurance company.	certify that the fees and expenses borne by the separate account, acquiring fund, and acquired fund in the aggregate are reasonable and consistent with the standard set forth in Section 26 of the 1940 Act.
Required Agreements	
Require a "participation agreement" between acquiring and acquired funds where such funds must: (1) agree to fulfill their responsibilities under the exemptive order; (2) notify the acquired fund prior to investing in excess of the limits of Section 12(d)(1)(A); and (3) provide the acquired fund a list of names of each of its affiliates.	Requires a Fund of Funds Investment Agreement between acquiring and acquired funds, unless the funds have the same adviser, that includes: (1) any material terms necessary for each adviser to make the appropriate finding under the rule; (2) a termination provision; and (3) a requirement that the acquired fund provide fee and expense information to the acquiring fund.
Limits on Complex Structures	
Limit the ability of an acquired fund to invest in underlying funds (i.e., limits structures with three or more tiers of funds), subject to certain enumerated exceptions.	*Similar to prior exemptive orders and no-action relie*f. Prohibits a fund relying on Section 12(d)(1)(G) of the 1940 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 such second-tier fund is: (1) acquired pursuant to Rule 12d1-1; (2) structured as a master-feeder arrangement; (3) a subsidiary wholly owned and controlled by the acquired fund; (4) received as a dividend or as a result of a plan of reorganization of a company; or (5) acquired pursuant to exemptive relief from the SEC to engage in interfund borrowing and lending transactions.
No comparable condition imposed by prior exemptive orders, however, Sections 12(d)(1)(A)(i) and (ii) impose 3 percent and 5 percent limits, respectively, on an acquired funds' investments in underlying funds.	Allows an acquired fund to invest up to an additional 10 percent of its assets in other funds, including private funds, if such investments are made pursuant to Rule 12d1-1.
Layering of Fees	
Cap sales charges and service fees at limits under	*Eliminated by Rule 12d1-4, but see Required*

©2005-2026 K&L Gates LLP. All Rights Reserved.

Conditions in Prior Exemptive Orders	Conditions in Rule 12d1-4
current Financial Industry Regulatory Authority sales rule (Rule 2341) even in circumstances where the rule would not otherwise apply.	*Evaluations and Findings above.*
Require an acquiring fund's adviser to waive advisory fees in certain circumstances or require the acquiring fund's board to make certain findings regarding advisory fees.	*Eliminated by Rule 12d1-4, but see Required Evaluations and Findings above.*
Disclosure and Reporting	
Prospectus and sales literature must contain disclosure about fund of funds arrangements, including expense structure and additional expenses of investing in underlying funds.	*Not addressed by Rule 12d1-4.* Unlike the proposal, Rule 12d1-4 does not require a fund to disclose that it is (or at times may be) an acquiring fund under Rule 12d1-4. Form N-1A requires open-end funds to disclose “Acquired Fund Fees and Expenses” (AFFE) in the fee table. The SEC did not address AFFE as part of this rulemaking.
A fund must report on Form N-CEN whether it acquired securities of another fund in excess of the Section 12(d)(1) limits (except where relying on Rule 12d1-1) but not whether it relied on Section 12(d)(1)(G), Rule 12d1-2 or an exemptive order to do so. A fund must also report if it relied on any exemptive orders.	A management company must report on Form N-CEN whether it acquired securities of another fund in excess of the Section 12(d)(1) limits, including when it has holdings in other funds in reliance on Rule 12d1-4 or Section 12(d)(1)(G).
Recordkeeping	
Unaffiliated acquiring and acquired funds must maintain for a period not less than six years, the first two years in an easily accessible place: (1) records of the exemptive order; (2) records of the participation agreement; (3) a list of the names of each fund of funds affiliate and underwriting affiliate; and (4) a written copy of the policies and procedures, and any modifications, that the acquired funds put in place to monitor any purchases of securities from the acquiring fund of its affiliates. *No comparable condition imposed by prior*	Acquiring and acquired funds (both unaffiliated and affiliated) must maintain for a period of not less than five years, the first two years in an easily accessible place: (1) a copy of each Fund of Funds Investment Agreement in effect, or was in effect in the past five years, and any amendments; (2) a written record of the findings made under Rule 12d1-4 and the basis therefor; and (3) the certification from each insurance company required by Rule 12d1-4.

©2005-2026 K&L Gates LLP. All Rights Reserved.

Conditions in Prior Exemptive Orders	Conditions in Rule 12d1-4
exemptive orders with respect to affiliated funds, however, funds and UITs generally have compliance program-related recordkeeping procedures in place consistent with the type of retention period imposed by Rule 12d1-4.	

FOOTNOTES

[1] Fund of Funds Arrangements, SEC Release Nos. 33-10871 & IC-34045, p. 10 (Oct. 7, 2020) (the SEC Release).

[2] Private funds and unregistered investment companies still may acquire no more than 3 percent of a U.S. registered investment company pursuant to Section 12 of the 1940 Act.

[3] As of the date of this Alert, the SEC Release has not been published in the Federal Register.

[4] Rule 12d1-4 defines “advisory group” as either: (i) 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 (ii) an acquiring fund's investment sub-adviser and any person controlling, controlled by, or under common control with such investment sub-adviser.

[5] *SEC Release*, at 56.

[6] Funds relying on Rule 12d1-4 must enter into fund investment agreements to obtain flexibility to invest in funds in the same fund group as well as in outside funds and non-fund assets if the funds do not have the same investment adviser.

[7] This is particularly true for acquired funds that are listed closed-end funds if acquiring funds that are private funds with the same investment adviser choose not to consider themselves part of the same advisory group.

[8] The 10 Percent Bucket is an acquisition test. If an existing acquired fund holds more than 10 percent of its total assets in underlying funds pursuant to an existing exemptive order, the acquired fund would not be required to dispose of those holdings after the rescission of its exemptive order and the effective date of Rule 12d1-4. However, the acquired fund could invest additional assets in underlying funds only in accordance with the terms of Rule 12d1-4.

[9] Rule 12d1-4 defines “baskets” to have the same meaning as in Rule 6c-11(a)(1) under the 1940 Act.

[10] The major topical areas of prior exemptive relief that are within the scope of Rule 12d1-4 are as follows: (i) Standard Fund of Funds Relief; (ii) Fund of Funds Relief for ETFs and ETMFs; (iii) Fund of Funds Direct Investment Relief; (iv) Fund of Funds Affiliated Structures; and (v) Captive Funds (*SEC Release*, at 140).

[11] For example, the SEC is not rescinding exemptive orders providing relief from Section 12(d)(1)(A) and (B) allowing certain interfund lending arrangements as such exemptive relief is outside the scope of Rule 12d1-4. The major topical areas of Section 12(d)(1) exemptive relief that the SEC believes are outside the scope of Rule 12d1-4 are: (i) Interfund Lending; (ii) Affiliated Insurance Fund Relief; (iii) Transaction-Specific Relief; (iv) Grantor

©2005-2026 K&L Gates LLP. All Rights Reserved.

Trusts; and (v) Fund of Funds Arrangements with Managed Risk Provision and other Relief Related to Section 12(d)(1)(E) (*SEC Release*, at 146).

[12] *See* Northern Lights Fund Trust, SEC Staff No-Action Letter (June 29, 2015). The SEC Release identifies this letter as no-action relief that will be withdrawn. The SEC Release states that "the list of no-action letters to be withdrawn will be available on the Commission's website."

[13] Consistent with prior exemptive orders, the rule exempts from the control and voting conditions: (i) an acquiring fund that is part of the same fund group as the acquired fund; and (ii) an acquiring fund that has a sub-adviser that acts as adviser to the acquired fund.

KEY CONTACTS



JON-LUC DUPUY
PARTNER

BOSTON
+1.617.261.3146
JON-LUC.DUPUY@KLGATES.COM



MARK P. GOSHKO
PARTNER

BOSTON
+1.617.261.3163
MARK.GOSHKO@KLGATES.COM



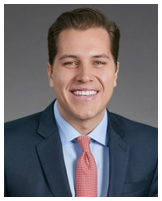
ABIGAIL P. HEMNES
PARTNER

BOSTON
+1.617.951.9053
ABIGAIL.HEMNES@KLGATES.COM



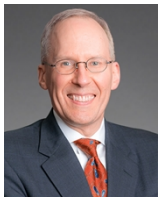
JENNIFER R. GONZALEZ
PARTNER

WASHINGTON, DC
+1.202.778.9286
JENNIFER.GONZALEZ@KLGATES.COM



JORDAN A. KNIGHT
ASSOCIATE

BOSTON
+1.617.951.9253
JORDAN.KNIGHT@KLGATES.COM



GEORGE ZORNADA
PARTNER

BOSTON
+1.617.261.3231
GEORGE.ZORNADA@KLGATES.COM



FATIMA S. SULAIMAN
PARTNER

WASHINGTON, DC
+1.202.778.9082
FATIMA.SULAIMAN@KLGATES.COM

©2005-2026 K&L Gates LLP. All Rights Reserved.

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.

©2005-2026 K&L Gates LLP. All Rights Reserved.