Investment Management Alert

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Thomas A. DeCapo
Partner / Boston
617.573.4814
thomas.decapo@skadden.com

Kevin T. Hardy
Partner / Chicago
312.407.0641
kevin.hardy@skadden.com

Michael K. Hoffman
Partner / New York
212.735.3406
michael.hoffman@skadden.com

Kenneth E. Burdon
Counsel / Boston
617.573.4836
kenneth.burdon@skadden.com

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One Manhattan West
New York, NY 10001
212.735.3000

SEC Adopts New Rule for Fund of Fund Arrangements

On October 7, 2020, the Securities and Exchange Commission (SEC) adopted Rule 12d1-4 (Final Rule or Rule 12d1-4) under the Investment Company Act of 1940 (1940 Act) in an effort to streamline and enhance the regulatory framework for "fund of funds" arrangements.[1] In connection with the adoption of Rule 12d1-4, the SEC is rescinding Rule 12d1-2 under the 1940 Act and most of the existing exemptive orders granting relief from Sections 12(d)(1)(A), (B), (C) and (G) of the 1940 Act. In addition, the SEC also is adopting related amendments to Rule 12d1-1 under the 1940 Act and Form N-CEN.

In response to numerous comment letters, including a letter from Skadden[2] (Skadden Letter), the Final Rule includes provisions specifically designed to protect closed-end funds[3] from undue influence resulting from acquiring funds' use of the Final Rule.[4] The Final Rule provides closed-end funds with a modicum of protection against opportunistic short-term investors that seek to use other registered funds to acquire shares of closed-end funds at a discount and pursue disruptive agendas.[5] However, significant unaddressed issues remain relating to private funds' ability to circumvent the protections of Section 12(d)(1)(A) and Section 12(d)(1)(C), which we address at the end of this mailing.

Background

Section 12(d)(1) of the 1940 Act limits the ability of a registered fund to invest in securities issued by another registered fund beyond certain thresholds. Section 12(d)(1)(A) of the 1940 Act prohibits a registered fund (and companies, including funds, it controls) from:

- acquiring more than 3% of another registered fund's outstanding voting securities;[6]
- investing more than 5% of its total assets in any one registered fund; or
- investing more than 10% of its total assets in registered funds generally.

[1] Fund of Funds Arrangements, Release Nos. 33-10871; IC-34045 (Oct. 7, 2020) (Adopting Release).

[2] Letter of Skadden, Arps, Slate, Meagher & Flom LLP, dated May 2, 2019, regarding Fund of Funds Arrangements (Release Nos. 33-10590; IC-33329).

[3] "Closed-end funds," as used herein, includes registered closed-end funds and closed-end investment companies that have elected to be regulated as business development companies (BDCs) under Section 54(a) of the 1940 Act.

[4] Fund of Funds Arrangements, Release Nos. 33-10590; IC-33329 (Dec. 18, 2019) (Proposing Release).

[5] *See* Recommendations Regarding the Availability of Closed-End Fund Takeover Defenses, Investment Company Institute (Mar. 2020) (ICI CEF Takeover Defenses Report).

[6] This restriction also applies to private funds relying on Section 3(c)(1) or Section 3(c)(7) under the 1940 Act.

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Section 12(d)(1)(B) of the 1940 Act addresses the other side of the transaction by prohibiting a registered open-end fund, and any principal underwriter thereof or broker-dealer registered under the Securities Exchange Act of 1934 (Exchange Act), from knowingly selling securities to any other investment company if, after the sale, the acquiring fund would:

- together with companies it controls, own more than 3% of the acquired fund's outstanding voting securities; or
- together with other funds (and companies they control), own more than 10% of the acquired fund's outstanding voting securities.

Section 12(d)(1)(C) prohibits registered funds (together with companies or funds they control and other registered funds that have the same adviser) from acquiring more than 10% of the outstanding voting stock of a registered closed-end fund.

These restrictions are designed to prevent fund of funds arrangements that, among other things: (i) allow the acquiring fund to control the assets of the acquired fund and use those assets to enrich the acquiring fund at the expense of acquired fund shareholders, (ii) create the potential for duplicative and excessive fees when one fund invests in another and (iii) would otherwise permit the formation of overly complex structures, or "pyramiding," that could be confusing to investors.[7]

One area of particular concern to closed-end funds is that the restrictions under Section 12(d)(1) of the 1940 Act can be easily circumvented. Private funds are expressly subject to the 3% acquisition limit in Section 12(d)(1)(A) of the 1940 Act, but this provision has been interpreted to not require aggregation across related acquiring funds and other accounts with a common investment adviser. On the other hand, the 10% acquisition limit in Section 12(d)(1)(C) of the 1940 Act expressly requires such aggregation among acquiring funds having the same investment adviser, but Section 12(d)(1)(C) does not apply at all to private acquiring funds. As a result, a group of affiliated private funds managed by the same investment adviser may in concert acquire shares of a closed-end fund in any amount without regard to either Section 12(d)(1)(A) or 12(d)(1)(C). The Final Rule does nothing to address this anomaly.

Over time, both Congress and the SEC, acting pursuant to authority granted to it under the 1940 Act, have granted relief from these prohibitions on fund of fund arrangements. However, the combination of statutory exemptions, SEC rules, and exemptive orders has led to a regulatory framework where substantially similar fund of funds arrangements are subject to different conditions.[8]

Against this backdrop, in December 2018, the SEC proposed Rule 12d1-4 (Proposed Rule), which would permit a registered fund to acquire shares of another registered fund in excess of the limits of Section 12(d)(1) without obtaining an exemptive order from the SEC, subject to certain conditions. As originally proposed, the relief would have been self-executing and no consent of the acquired fund would have been required with respect to acquisitions of its shares made by an acquiring fund in reliance on the Proposed Rule. As stated in the Adopting Release, the SEC "believe[s] that [the framework of the Final Rule] will provide investors with the benefits of fund of funds arrangements, and will provide funds with investment flexibility to meet their investment objectives efficiently, in a manner consistent with the public interest and the protection of investors."

Overview of Rule 12d1-4

Rule 12d1-4 will permit a registered or regulated investment company[9] (an acquiring fund) to acquire the securities of any other registered or regulated investment company (an acquired fund) in excess of the limits in Section 12(d)(1) of the 1940 Act, provided certain conditions are met. The Final Rule's conditions include the following:

- **Required Fund of Funds Investment Agreements.** Rule 12d1-4 will require funds that do not have the same investment adviser to enter into an agreement prior to the purchase of acquired fund shares in excess of Section 12(d)(1)'s limits. This in effect renders acquisitions under Rule 12d1-4 subject to the consent of the acquired fund, rather than self-executing.

[7] *See* Adopting Release at 7.

[8] For example, an acquiring fund could rely on Section 12(d)(1)(G) and Rule 12d1-2 when investing in an acquired fund within the same group of investment companies. Alternatively, the acquiring fund could rely on relief provided by an exemptive order, which would allow it to invest in substantially the same investments, but could require the fund to comply with different conditions.

[9] The Final Rule permits open-end funds, unit investment trusts (UITs), closed-end funds (including BDCs), exchange-traded funds (ETFs) and exchange-traded managed funds to rely on the rule as both acquiring and acquired funds. It is important to note that private funds may not rely on the Final Rule. However, this exclusion is of little import to acquired closed-end funds in that, as noted above, affiliated private funds acting in concert are not subject to the existing limits in Sections 12(d)(1)(A) and 12(d)(1)(C) of the 1940 Act. Private funds individually will continue to be prohibited from acquiring more than 3% of a U.S. registered fund under Section 12(d)(1)(A). In addition, while private funds are not subject to the Final Rule, such funds could still be considered part of an "advisory group" if the funds' manager also manages a registered fund that is relying on the Final Rule.

- **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 factors, including that concerns about the potential for undue influence have been addressed.
- **Voting Requirements.** Rule 12d1-4 will require an acquiring fund relying on the rule and its "advisory group"[10] to use mirror voting[11] if it holds more than 25% of an acquired open-end fund due to a decrease in the outstanding securities of the acquired fund and if it holds more than 10% of a closed-end fund, except in certain limited circumstances.
- **Limits on Control.** Rule 12d1-4 will prohibit an acquiring fund and its advisory group from controlling an acquired fund, except in certain limited circumstances.
- **Limits on Complex Structures.** Rule 12d1-4 will impose a general prohibition on three-tiered structures with certain enumerated exceptions. However, in addition to these exceptions, Rule 12d1-4 will allow an acquired fund to invest up to 10% of its total assets in other funds (including private funds), without regard to the purpose of the investment or types of underlying funds.

Each of these conditions is discussed in further detail below.

Fund of Funds Investment Agreements

Perhaps the most important provision of the Final Rule is the requirement that funds enter into a fund of funds investment agreement before the acquiring fund acquires securities of the acquired fund in excess of the limits of Section 12(d)(1) in reliance on the rule, unless both funds have the same adviser.[12] This requirement effectively requires the consent of the acquired fund in order for an acquiring fund to acquire shares in reliance on the Final Rule. While the parties are generally free to negotiate the terms of the agreement, the Final Rule requires that any such agreement contain three specific provisions:

- First, the fund of funds investment agreement must include any material terms necessary for the adviser, underwriter or depositor to make the required findings noted below under "Required Evaluations and Findings," including that any concern of undue influence by the acquiring fund has been addressed.
- Second, each fund of funds investment agreement must include a termination provision whereby either party can terminate the agreement with advance written notice within a period no longer than 60 days.
- Third, the agreement must include a provision requiring an acquired fund to provide the acquiring fund with fee and expense information to the extent reasonably requested.

The requirement of a fund of funds investment agreement will likely prove to be a significant tool in protecting closed-end funds against undue influence by certain opportunistic short-term investors seeking to use one or more registered funds to acquire closed-end fund shares. In essence, the requirement allows an acquired fund to block an investment if the fund's investment adviser believes that the investment would allow the acquiring fund to exert undue influence. If the acquired fund prefers, it may be able to negotiate terms that would satisfy the acquired fund's concern over undue influence (thus permitting the required findings), which could include, for example:

- setting ownership limits more restrictive than those in the Final Rule;
- requiring an acquiring fund to aggregate related party, account or group ownership not falling within the Final Rule (*i.e.*, private funds and related separate accounts);
- requiring that shares below the 3% threshold be voted as set forth in the agreement; or
- contractual divestment triggers.[13]

The requirement that either party be able to terminate the agreement upon 60 days' notice raises problematic uncertainty. The Adopting Release provides little guidance on whether certain provisions and covenants may survive termination of the agreement, although it does suggest at a minimum that the parties may agree that termination requires divestment and that such a requirement would survive termination of the agreement. However, these contractual divestment obligations upon termination, especially in cases of large holdings, could result in downward pressure on an acquired closed-end fund's share price and put pressure on a fund's board to waive the requirement

[10] The Final Rule 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." Rule 12d1-4(d).

[11] Mirror voting requires the acquiring fund and its advisory group to vote the shares held by it in the same proportion as the vote of all other holders of the acquired fund. In mirror voting, the tabulation agent for the shareholder meeting will first tabulate the votes for a proposal and then apply the resulting ratio (for/against/abstain) to the shares instructing that they are to be mirror voted.

[12] It is important to note that the exception to the Final Rule only applies in instances where funds have the same investment adviser (*i.e.*, the exception does not extend to advisers under the common control, in which case a fund of funds investment agreement would be necessary).

[13] Under the Final Rule, termination of the agreement does not, unless otherwise agreed to by the parties, require that the acquiring fund reduce its position in the acquired fund, but it does prevent the acquiring fund from purchasing additional shares of the acquired fund beyond the limits of Section 12(d)(1).

— precisely the type of undue influence that was sought to be addressed in the first instance. Accordingly, closed-end funds should carefully consider whether to enter into a fund of funds investment agreement at all, and if they do, funds should negotiate the agreements in order to ensure that they are protected against the types of undue influence and abuses that Section 12(d)(1) of the 1940 Act is designed to prevent.

As noted above, a fund of funds investment agreement is not required where an acquiring fund and an acquired fund are advised by the same investment adviser. However, it is important to note that this exception only applies where the investment adviser is the primary adviser to each of the acquiring fund and the acquired fund (*i.e.*, the exception will not be available when an investment adviser acts as an adviser to one fund and a sub-adviser to the other fund or in instances where the adviser acts as sub-adviser to both funds). As with the required evaluations and findings, advisers should be aware of their fiduciary duties to both funds. If an adviser believes that it cannot satisfy its fiduciary duty to both funds in a fund of funds arrangement, the adviser should not enter into the arrangement.

Required Evaluations and Findings

Whereas the Proposed Rule had included a redemption limit[14] and a requirement that funds disclose whether they are or may be an acquiring fund, the Final Rule instead requires that investment advisers evaluate a proposed fund of funds arrangement and make certain findings.

The Final Rule requires an investment adviser to a management company operating in accordance with the rule to evaluate and make certain findings regarding the fund of funds arrangement. Specifically, the Final Rule will require: (i) an acquired management company's adviser to make certain findings focused on addressing undue influence concerns, including through redemptions, by considering specific enumerated factors; and (ii) an acquiring fund's adviser, principal underwriter or depositor to conduct an evaluation of 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.

For acquired funds, the Final Rule will require the acquired fund's investment adviser to find that any undue influence concerns associated with the acquiring fund's investment in the acquired fund are reasonably addressed, after considering certain specific factors. These factors are: (i) the scale of contemplated investments by the acquiring fund and any maximum investment limits; (ii) the anticipated timing of redemption requests by the acquiring fund; (iii) whether, and under what circumstances, the acquiring fund will provide advance notification of investment and redemptions; and (iv) 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. Although criteria (ii) though (iv) are designed specifically to address concerns of investment companies that offer a redemption feature (*i.e.*, open-end funds), this list is not exhaustive.[15] Investment advisers of acquired funds will likely seek to carefully evaluate all relevant factors and come to the conclusion that any undue influence concerns associated with an acquiring fund's investment in an acquired fund are reasonably addressed prior to making its findings with regard to a particular investment. For closed-end funds, this means that an acquired fund's investment adviser also is likely to take into account the potential for undue influence and potential harm to long-term shareholders.

For acquiring funds, the Final Rule will require the acquiring fund's adviser to evaluate the complexity of the structure associated with the acquiring fund's investment in the acquired fund. Also, the acquiring fund's adviser 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.

In all instances, the required analysis, and any findings based thereon, will be subject to the adviser's fiduciary duty to act in the best interest of the fund or funds that it advises. Further, the Final Rule requires the investment adviser to each of the acquiring and acquired funds to report its evaluation, its 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.

[14] The Proposed Rule would have prohibited 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.

[15] "If the acquired fund is a management company, prior to the initial acquisition of an acquired fund in excess of the limits in Section 12(d)(1)(A)(i) of the Act (15 U.S.C. 80a-12(d)(1)(A)(i)), the acquired fund's investment adviser must find that any undue influence concerns associated with the acquiring fund's investment in the acquired fund are reasonably addressed and, as part of this finding, *the investment adviser must consider at a minimum the following items … .*" (emphasis added). *See* Rule 12d1-4(b)(2)(i)(B).

Voting Requirements

In an important change from the Proposed Rule,[16] the Final Rule will require an acquiring fund and its advisory group to vote their shares of an acquired fund using mirror voting if the acquiring fund and its advisory group (in the aggregate) hold: (i) more than 25% of the outstanding voting securities of an acquired open-end fund due to a decrease in the outstanding securities of the acquired fund or (ii) more than 10% of the outstanding voting securities of an acquired closed-end fund. Although there is a limited exception to the mirror-voting requirement,[17] the import of the Final Rule is that the requirement will apply in the vast majority of instances where an advisory group exceeds the stated thresholds.

The requirement to use only mirror voting (except in very limited circumstances) represents an important tool in countering the ability of opportunistic short-term investors to exert undue influence on closed-end funds and was strongly supported by Skadden and others who submitted comments on this aspect of the Proposed Rule.

Exceptions to the Control and Voting Conditions

The Final Rule contains two notable exceptions to the control and voting conditions. These conditions will not be applicable when: (i) an acquiring fund is within the same group of investment companies[18] 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. While the Final Rule will subject fund of funds arrangements within these exclusions to a more limited set of conditions than other fund of funds arrangements, fund of funds arrangements within these exclusions are still subject to other protections.[19]

Limits on Control

The Final Rule will prohibit an acquiring fund and its advisory group from controlling, individually or in the aggregate, an acquired fund, except under certain circumstances. An acquiring fund will be required to aggregate its investment in an acquired fund with the investment of the acquiring fund's "advisory group" for purposes of evaluating control.

The 1940 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. The 1940 Act also creates a rebuttable presumption that any person who, directly or indirectly, beneficially owns more than 25% of the voting securities of a company controls the company and that any person who does not own that amount does 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. 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. Therefore, this condition effectively limits ownership of an acquired fund by an acquiring fund and its advisory group to 25% of its outstanding voting securities. However, control could arise at lower ownership levels depending on the facts and circumstances.

Although many commenters, including Skadden, had suggested that the definition of "advisory group" be expanded to include any account managed by the acquiring fund's investment adviser, sub-adviser or any of their respective control affiliates, the SEC adopted Rule 12d1-4 as proposed, leaving potential loopholes that could allow an activist manager to make an end-run around the requirements of Rule 12d1-4 by using separately managed accounts or taking the position that control over a related private fund does not exist. That said, the other conditions imposed by Rule 12d1-4 likely limit the possibility of abuse via this loophole — particularly the requirement for a fund of funds investment agreement discussed above, which could itself contractually impose aggregation among all accounts managed by the same investment adviser.

[16] Under the Proposed Rule, an acquiring fund and its advisory group would have been required to use pass-through or mirror voting when the acquiring fund and its advisory group, in the aggregate, hold more than 3% of an acquired fund's outstanding voting securities. In pass-through voting, the acquiring fund must "seek instructions from its security holders with regard to the voting of all proxies with respect to [the acquired fund] and ... vote such proxies only in accordance with such instructions," and in mirror voting, the acquiring fund must "vote the [acquired fund] shares held by it in the same proportion as the vote of all other holders of such security." *See* 15 U.S.C. 80a-12(d)(1)(E)(iii)(aa).

[17] In circumstances where Rule 12d1-4 or Section 12(d)(1) requires all of the security holders of an acquired fund to engage in mirror voting and it would not be possible for every shareholder to engage in mirror voting, such acquiring funds must use pass-through voting. For example, if an acquired fund is offered solely to acquiring funds that rely on Rule 12d1-4, there may be no other investors to vote the acquired fund shares; therefore, under these circumstances, the vote must be "passed through" to the acquiring funds' shareholders.

[18] "Group of investment companies" is defined 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."

[19] For example, in circumstances where the acquiring fund and acquired fund share the same adviser, the adviser would owe a fiduciary duty to both funds, serving to protect the best interests of each fund.

Complex Structures

In order to protect against complex, multi-tier fund structures that could lead to excessive fees and investor confusion, the Final Rule generally restricts fund of fund arrangements to two tiers, subject to certain limited exceptions.

The Final Rule prohibits a fund that is relying on the rule or Section 12(d)(1)(G)[20] of the 1940 Act from acquiring, in excess of the limits in Section 12(d)(1)(A), the outstanding voting securities of an acquiring fund, unless this second-tier fund makes investments permitted by Rule 12d1-4(b)(3)(ii) under the 1940 Act. Said differently, an acquiring fund under Section 12(d)(1)(G) of the 1940 Act may not acquire the securities of an acquiring fund under Rule 12d1-4 in excess of the limits of Section 12(d)(1)(A) of the 1940 Act, except under certain limited circumstances. It is important to note that this provision will not prevent a fund from investing all of its assets in an acquiring fund in reliance on Section 12(d)(1)(E) of the 1940 Act (*i.e.*, a master-feeder arrangement).

In addition, the Final Rule also will generally prohibit a situation where an acquired fund invests in other investment companies or private funds in excess of the limits in Section 12(d)(1)(A) of the 1940 Act. Specifically, the Final Rule states that 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 exceptions. These exceptions include: (i) securities acquired in reliance on Section 12(d)(1)(E) of the 1940 Act (*i.e.*, master-feeder arrangements); (ii) securities acquired pursuant to Rule 12d1-1[21] under the 1940 Act; (iii) securities of a subsidiary wholly owned and controlled by the acquired fund; (iv) securities received as a dividend or as a result of a plan of reorganization of a company; or (v) securities acquired pursuant to exemptive relief from the SEC to engage in interfund borrowing and lending transactions. This effectively gives acquired funds subject to Rule 12d1-4 a "10% bucket" of other investment companies and private funds in which they can invest beyond any applicable limits in Section 12(d)(1)(A) of the 1940 Act.[22]

[20] Section 12(d)(1)(G) allows a registered open-end fund or UIT to acquire an unlimited amount of shares of other open-end funds and UITs that are in the same "group of investment companies," subject to certain conditions.

[21] Rule 12d1-1 allows funds to invest in shares of money market funds in excess of the limits of Section 12(d)(1).

[22] While registered fund investments in private funds are not restricted by Section 12(d)(1), reliance on the Final Rule as an acquired fund will result in the limitation described herein due to concerns about creating overly complex structures.

Exemptions From Section 17(a) of the 1940 Act

The Final Rule includes an explicit exemption from Section 17(a) of the 1940 Act. Specifically, the Final Rule provides that if the rules' conditions are satisfied:

- an acquiring fund may purchase or otherwise acquire the securities issued by another registered investment company (other than a face-amount certificate company) or business development company (an "acquired fund"); and
- an acquired fund, any principal underwriter thereof, and any broker or dealer registered under the Securities Exchange Act of 1934 may sell or otherwise dispose of the securities issued by the acquired fund to any acquiring fund and any acquired fund may redeem or repurchase any securities issued by the acquired fund from any acquiring fund.[23]

As noted in the Adopting Release, "[a]bsent an exemption, Section 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 rule 12d1-4."[24]

Recordkeeping

The Final Rule requires the acquiring and acquired funds that participate in fund of funds arrangements in accordance with the rule to maintain and preserve certain written records for a period of not less than five years, the first two years in an easily accessible place. These records include: (i) a copy of each fund of funds investment agreement that is in effect, or was in effect in the past five years, and any amendments thereto; and (ii) a written record of the relevant findings made under Rule 12d1-4 and the basis therefor within the past five years.

Rescission of Rule 12d1-2 and Certain Exemptive Relief

In an effort to channel fund of funds arrangements into the framework of the Final Rule, the SEC is rescinding Rule 12d1-2 under the 1940 Act, which had permitted funds that primarily invest in funds within the same fund group to invest in unaffiliated funds and nonfund assets. As a result, funds wishing to create certain types of fund of funds arrangements will be required to rely on the Final Rule or Section 12(d)(1)(G). Funds currently relying on Rule 12d1-2 will have one year from the effective date of the Final Rule to bring their operations into compliance.

The SEC also is rescinding previously granted exemptive relief to the extent that such relief falls within the scope of the Final Rule. Specifically, the SEC is rescinding all exemptive relief that

[23] Rule 12d1-4(a)(1)-(2). The Final Rule also provides an exemption from Section 17(a) of the 1940 Act for certain transactions with affiliated ETFs.

[24] Adopting Release at 24.

permits investments in funds beyond the limits in 12(d)(1)(A), (B) or (C) of the 1940 Act, with certain limited exceptions, and all exemptive relief under Section 12(d)(1)(G) of the 1940 Act that permits an affiliated fund of funds to invest in assets that are beyond the scope of that statutory provision.

The relief being rescinded includes, but is not limited to: (i) standard fund of funds relief; (ii) fund of funds relief for ETFs and exchange-traded mutual funds (ETMFs); (iii) ETFs relying on Rule 6c-11 under the 1940 Act; (iv) fund of funds relief for non-transparent ETFs and ETMFs; (v) fund of funds direct investment relief; (vi) fund of funds affiliated structures; and (vii) captive funds.

Among those categories of exemptive relief that are not being rescinded are: (i) interfund lending; (ii) affiliated insurance fund relief; (iii) transaction-specific relief; (iv) grantor trusts; (v) fund of funds arrangements with managed risk provision; and (vi) certain other relief related to Section 12(d)(1)(E) under the 1940 Act.

Other Amendments

The SEC is amending 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.

The SEC also is 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 1940 Act during the applicable reporting period.

Compliance Dates

- The Final Rule will become effective 60 days after publication in the Federal Register.
- Rule 12d1-2 and the exemptive relief discussed above will be rescinded one year from the effective date of the Final Rule.
- The amendments to Form N-CEN will be effective one year from the effective date of the Final Rule.

Unaddressed Topics — Further Reform Needed

The Final Rule reflects a number of provisions that appear to have been adopted or revised in direct response to the advocacy efforts of closed-end fund industry participants, including Skadden, during the comment period. However, as noted above, the Final Rule does nothing to address the easy circumvention of the 3% limitation in Section 12(d)(1)(A) and 10% limitation in Section 12(d)(1)(C) that certain opportunistic short-term investors achieve through the use of private funds.[25] In the Adopting Release, the SEC noted that it had received comment letters both for and against action that would address this issue. The SEC stated that, "[a]fter considering comments, [it] believe[s] commenters' additional recommendations with respect to investments in closed-end funds that are within the statutory limitations of Section 12(d)(1) are beyond the scope of the [Rule 12d1-4] rulemaking."

Important here is the SEC's acknowledgement of the concern that ownership of a closed-end fund in excess of 10% by an acquiring fund could result in the acquiring fund's advisory group having the ability to exert undue influence on an acquired closed-end fund.[26] This acknowledgement could bode well for continued advocacy by the closed-end fund industry to seek a solution to the continuing threat to closed-end funds of coordinated action by private funds and their related persons to amass large voting stakes in closed-end funds that enable them to exert undue influence on the closed-end fund to the detriment of long-term shareholders.[27]

Congress added Section 12(d)(1)(A) to the 1940 Act in the Investment Company Amendments Act of 1970.[28] These provisions were added to address the emergence of the "fund holding company" — or, in other words, "fund on funds" arrangements where an investment company's portfolio consisted either entirely or largely of securities of other investment companies.[29] Of particular concern was that fund holdings companies "pose a real potential for the exercise of undue influence or control over the activities of portfolio funds."[30] One of the dangers of the fund holding company structure identified in the PPI Report was the inducement of deviations from the investment program or policies of registered companies subject to the influence of the fund holding company, and that such influence could cause management of the fund to pass to persons other than those chosen by shareholders to perform that function.[31] While much of this discussion in the PPI Report focused on how the threat of large-scale redemptions in mutual funds could give rise to

[25] *See* ICI CEF Takeover Defenses Report.

[26] Specifically, the SEC noted that it was "concerned that a higher threshold for acquiring fund investments in closed-end funds, such as 15% or 25%, could give an acquiring fund's advisory group the ability to dictate certain fund actions and unduly influence the acquired closed-end fund." *See* Proposing Release at 52.

[27] *See* ICI CEF Takeover Defense Report.

[28] Pub. L. No. 91-547, 84 Stat. 1413, 1417 (1970).

[29] *See* Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 89-2337 (1966), at 311 (PPI Report).

[30] *Id.* at 315.

[31] *Id.* at 316.

the potential harms of a fund-holding company structure, it also expressly stated, "Although the acquisition of the stock of closed-end companies does not pose the same problem of control through the right of redemption, the power to vote a significant block of stock of a closed-end company may represent potential for exercise of control."[32]

The manner in which professional opportunistic short-term investors can circumvent the 3% limit of Section 12(d)(1)(A) and the 10% limit of Section 12(d)(1)(C) through the use of private funds gives rise to the very undue influence that Congress sought to prohibit in Section 12(d)(1) of the 1940 Act.[33] The SEC in the Adopting Release acknowledges the concern that ownership in excess of 10% of a closed-end fund can confer the ability to exert undue influence. There is no substantive difference between that 10% being owned in one registered fund, or in five affiliated private funds all controlled by the same manager.

Moreover, a plain reading of the 1940 Act indicates that related private funds having the same investment adviser, and the investment adviser itself, are all affiliated persons, or affiliated persons of affiliated persons, of an acquired closed-end fund when one or several of them, acting in concert, acquire in excess of 5% of the outstanding voting securities of the acquired closed-end fund, and thus are all subject to the restriction on joint transactions set forth in Section 17(d) of the 1940 Act and Rule 17d-1 thereunder. The SEC has expressly stated that "Section 17(d) of the [1940] Act was designed to prevent affiliated persons from exerting undue influence over investment companies by causing them to engage in transactions that confer disparate benefits on such persons."[34] With the SEC having concluded that ownership in excess of 10% of a closed-end fund invokes concerns over the ability of an acquiring fund and its advisory group to exert undue influence on an acquired closed-end fund, the closed-end fund industry may wish to encourage the SEC to follow up this Section 12(d)(1) rulemaking with an additional rulemaking under Section 17(d) of the 1940 Act to address this concern, to the extent the SEC does not believe it has the authority to address this issue in the context of a Section 12(d)(1) rulemaking.

The closed-end fund industry may wish to continue to press for interpretive, rulemaking or legislative solutions to stop professional opportunistic short-term investors from continuing to avoid the substantive protections of the 3% limit of Section 12(d)(1)(A) and the 10% limit of Section 12(d)(1)(C) in order to gain the ability to exert undue influence on an acquired closed-end fund.

[32] *Id.* at 324.

[33] *See* ICI CEF Takeover Defense Report.

[34] In the Matter of Sequoia Partners, L.P., Investment Company Act Release No. 20644 (Oct. 20, 1994).