

The New Fund-of-Funds Rule: The Good, the Bad and the Ugly for Closed-End Funds and BDCs

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On October 7, 2020, the SEC adopted Rule 12d1-4 and related amendments, which together will replace the current regulatory patchwork of registered fund-of-funds no-action letters, statutory interpretations and exemptive orders with a rules-based regulatory framework. As discussed in a prior [Alert](#), Rule 12d1-4 was proposed on December 19, 2018 and was subject to substantial industry comment. The final Rule has been fairly widely praised by the industry; however, we think it is more of a mixed bag and has some significant potential negative effects for the democratization of private markets investments.

In broad strokes, Rule 12d1-4 will permit a registered investment company or BDC (an “Acquiring Fund”) to acquire the securities of any other registered investment company or BDC (an “Acquired Fund”) in excess of the so-called “3/5/10” limits that form the basis of the anti-pyramiding provisions of the 1940 Act, subject to certain limitations on control and voting.^[1] Rule 12d1-4 also would require that an Acquiring Fund relying on the Rule, and its investment adviser, make certain evaluations and findings.

The SEC also will rescind, with limited exceptions, current exemptive orders for fund-of-funds arrangements, as well as Rule 12d1-2, which expands the types of instruments that open-end funds and unit investment trusts that primarily invest in funds within the same fund group can invest in when relying on Section 12(d)(1)(G) of the 1940 Act.^[2]

In this Alert we discuss certain potential implications of the new rule for closed-end funds and BDCs. Rule 12d1-4 and related amendments to Rule 12d1-1 became effective as of January 19, 2021. The rescission of Rule 12d1-2 and current fund-of-funds exemptive orders will be effective on January 19, 2022. Funds must comply with related changes to Form N-CEN (requiring 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) by January 22, 2022.

The Good

Rule 12d1-4 allows for the creation of new products

Because Rule 12d1-4 would permit any type of Acquiring Fund to exceed the 1940 Act's "3/5/10" limits, closed-end funds and BDCs may now exceed the "3/5/10" limits without exemptive relief, which was previously available only to open-end funds and unit investment trusts relying on Rule 12d1-2. By extending fund-of-funds relief to closed-end funds and BDCs, we believe that Rule 12d1-4 could allow for new categories of closed-end products that can provide investors with the benefit of diversified access to other funds. For example, closed-end fund-of-funds could pursue strategies comprised of BDCs, real estate or other closed-end funds, which were previously limited under prior rulemaking or exemptive relief. For retail investors, the benefit of these structures could be to provide indirect access to funds (or share classes) that an individual investor might not be able to purchase on their own due to investment minimums or investor qualifications (*e.g.*, a closed-end fund that charges a performance fee is limited to "qualified clients" with \$2.1 million in net worth or \$1 million in assets managed by the closed-end fund's adviser). Due to regulatory requirements prohibiting BDCs from investing more than 30% of their assets in other funds, BDC's will still be practically limited in their ability to take advantage of some of the fund-of-fund benefits provided by Rule 12d1-4 as Acquiring Funds. While BDCs may face limits in their ability to be Acquiring Funds, BDCs may see increased interest as Acquired Funds from funds-of-funds pursuing a BDC-like investment strategy (especially if the SEC addresses the AFFE issue that artificially curbs the regulated funds' interest in investing in BDCs as discussed earlier in this Alert).

Rule 12d1-4 will also allow fund-of-funds arrangements when: (i) the Acquiring Fund and Acquired Fund hold themselves out to investors as being part of the same group of investment companies; or (ii) the Acquired Fund's investment adviser is affiliated through control with the Acquiring Fund's sub-adviser. This provides an exemption from Section 17 of the 1940 Act, which otherwise would not permit an Acquiring Fund to "seed" affiliated registered funds and BDCs. Funds that comply with the conditions in Rule 12d1-4 may rely upon this exemption from Section 17(a) even if they are not relying upon the Rule for an exemption from the "3/5/10" limits. However, we note that the Rule 17d-1 prohibition on joint transactions could be implicated if one regulated fund seeds an affiliated regulated fund, despite the Section 17(a) exemption. Depending on the facts of a particular arrangement, it is possible that the use of an Acquiring Fund's assets to seed an affiliated Acquired Fund could be viewed as impermissibly disadvantaging the Acquiring Fund for the benefit of the Acquired Fund (or its adviser).

Rule 12d1-4 could impact certain closed-end fund activists that utilize registered funds

The SEC responded to industry comments regarding certain activism risks that could arise under the initial proposal for Rule 12d1-4. The final version of the Rule requires an Acquiring Fund that does not share the same investment adviser as an Acquired Fund to enter into a fund-of-funds investment agreement, similar to participation agreements under current fund-of-funds exemptive orders. In practice, most participation agreements concern ETFs, which do not have the same activist concerns as listed closed-end funds and BDCs. The requirement for an Acquiring Fund to enter into an investment agreement under Rule 12d1-4 provides registered funds and BDCs with a shield against activists who utilize registered funds, as an activist fund could not acquire more than 3% of an Acquired Fund without entering into an investment agreement. **As a result, managers of closed-end funds and BDCs can prevent a true activist from relying on the rule to invest in their funds by refusing to enter into an investment agreement with the activist.**

When a potential Acquired Fund determines to allow an investor to rely on the rule, the Rule lays out certain terms that an investment agreement must contain. However, there is no reason an agreement could not contain additional terms. Potential terms for an Acquired Fund that wants to accept the capital infusion offered by the potential Acquiring Fund, but is nonetheless concerned about potential future activist actions, to consider when approached by an Acquiring Fund include:

- Requiring the Acquiring Fund to vote its shares in accordance with board recommendations;
- Agreeing not to initiate any merger or acquisition activity relating to the Acquired Fund or to propose or vote for other activist ventures (*e.g.*, tender offers, open-ending a closed-end fund);
- Agreeing not to make any public statements related to the Acquired Fund;
- Making the terms of the investment agreement applicable to affiliates/related parties of the Acquiring Fund;

- Requiring the Acquiring Fund to abide by Rule 144A trading restrictions as if it were an affiliate for purposes of the Securities Act of 1933; and
- Ensuring obligations apply to the Acquiring Fund so long as it is invested in Acquired Fund (even if the Acquiring Fund's position drops below 3% of the Acquired Fund's shares or the investment agreement is terminated).

These terms are not typical of current participation agreements and would be appropriate for a potentially hostile or activist Acquiring Fund. It should be noted that a fund-of-funds investment agreement can be terminated by the Acquired Fund without penalty. Upon termination of a fund-of-funds investment agreement, the Acquiring Fund would not be required to divest its interest; accordingly, an Acquired Fund may want to consider which provisions will survive termination. Moreover, upon termination of a fund-of-funds investment agreement, the Acquiring Fund generally would not be able to rely on an exemption from the Section 12(d)(1)(A) limitations and would therefore be prohibited from purchasing additional shares of the Acquired Fund. Thus, even if an Acquired Fund's fund-of-funds investment agreements do not contain shareholder friendly covenants, the power to "freeze" unilaterally an Acquiring Fund's ownership of Acquired Fund shares can provide a modicum of protection if circumstances with a friendly Acquiring Fund should change.

Even if a closed-end fund or BDC that is an Acquired Fund agrees to enter into an investment agreement with a prospective Acquiring Fund without protective terms, the "advisory group" of an activist registered fund will be limited to owning no more than 10% of the Acquired Fund's assets. Under Rule 12d1-4, an "advisory group" that owns greater than 10% of an Acquired Fund's assets would be required to "mirror vote" all of its shares (i.e., in the same proportion as other shares cast), thereby eliminating the voting power of the advisory group. Consistent with prior exemptive orders, an Acquiring Fund must aggregate all securities owned by its "advisory group" in assessing both the control and voting thresholds, which includes an Acquiring Fund's investment adviser (or sub-adviser) or depositor, and any person controlling, controlled by, or under common control with such investment adviser (or sub-adviser) or depositor. An Acquired Fund's advisory group includes private funds and foreign funds controlled by or under common control with the investment adviser. Rule 12d1-4 also prohibits an Acquiring Fund and its advisory group from controlling an Acquired Fund within the meaning of the 1940 Act, which mean the advisory group cannot acquire more than 25% of the Acquired Fund's voting securities. In circumstances where Acquiring Funds are the only shareholders of an Acquired Fund, pass-through voting may be used. An Acquiring Fund that is part of the same fund group as the Acquired Fund and an Acquiring Fund that has a sub-adviser that acts as adviser to the Acquired Fund will not be subject to the control and voting requirements.

Use in friendly fund combinations

In the case of a friendly merger of registered investment funds or BDCs, Rule 12d1-4 would permit the Acquiring Fund to purchase greater than 3% of the target fund's shares to help obtain the requisite shareholder votes for the merger, such as transaction approvals and/or advisory agreement approvals. However, any "toehold" investment would be subject to Schedule 13D/G and Section 16 filings under the Securities and Exchange Act of 1934, as amended, as well as anti-trust filings under the Hart-Scott-Rodino Antitrust Improvements Act and state anti-takeover statutes such as §203 of the Delaware General Corporation Law or Maryland Commercial Law §3-603, as applicable.

The Bad

Failure to extend Rule 12d1-4 relief to private funds

Private funds will continue to be limited to owning no more than 3% of any single registered fund. Several industry commenters suggested that this limitation be softened with regard to private funds.^[3] We were disappointed that the SEC did not permit private funds to qualify as Acquiring Funds under Rule 12d1-4, although the adopting release encourages private funds to apply for exemptive orders in order to rely upon similar relief. Expressing an openness to granting private funds exemptive relief on this point is a positive development, but is not

necessarily a good use of Staff resources, given the unlikelihood that there will be significant, or any, differences in the framework under which a private fund may be an Acquiring Fund under the Rule. Given that an Acquiring Fund must enter into an investment agreement with an Acquired Fund in order to rely on the Rule, we believe that a more efficient approach would have been to include private fund relief in this Rule and free up Staff resources for other matters.

BDC AFFE relief not addressed

Despite strong industry support for the proposing release's request for comment on potentially excluding BDCs from the acquired funds' fees and expenses ("AFFE") disclosure requirements, the SEC did not adopt any AFFE changes in the final rule. Under Form N-1A and Form N-2, a registered fund or BDC must include in its fees and expense table a separate line item disclosing fees and expenses in connection with investments in other funds, which is also incorporated into the registered fund's total operating expense ratio. The relatively higher operational costs of BDC investment operations typically result in higher AFFEs for funds acquiring BDCs and therefore, higher total expense ratios for an Acquiring Fund. In 2014, in response to industry concerns regarding the impact of BDC AFFEs on total expense ratios, certain index providers removed BDCs as index constituents. In turn, mutual funds and ETFs that track indices were effectively barred from investing in BDCs, resulting in lower market demand for BDCs and corresponding calls for action from the BDC sector. As part of the Rule 12d1-4 proposing release, the SEC solicited comment on fees and expenses, including with respect to AFFE disclosure and whether to exempt BDCs in whole or in part, and received substantive feedback requesting relief. Although the SEC has proposed limited relief to the AFFE disclosure requirements,^[4] we believe that Rule 12d1-4 provided a prime opportunity for the SEC to respond to a substantive need of BDCs.

Activist protections could be more meaningful

We believe that Rule 12d1-4 could have included more meaningful activist protections for listed closed-end funds/BDCs, in line with the Staff's recent rescission of the Boulder no-action letter and Staff's statement on control share statutes.^[5] Proposed Rule 12d1-4 required mirror voting when an advisory group (which includes private and foreign funds) owned greater than 3% of a closed-end fund's voting securities, whereas the final rule only requires mirror voting at a 10% ownership threshold. Further, the voting restrictions under Rule 12d1-4 only apply to an advisory group that includes a registered fund or BDC relying on Rule 12d1-4. Advisory groups with a registered fund or BDC owning less than 3% of an Acquired Fund or that only include private funds and foreign funds could still in the aggregate own greater than 3% of a registered fund's by splitting each fund's individual allocations to less than 3% of the registered fund's securities. We believe that the SEC missed an opportunity to institute meaningful protections to protect the interests of shareholders of listed closed-end funds and BDCs in light of the multiple recent activist actions in the industry and the growing threat of future activist actions.^[6]

The Ugly

Negative impact on retailization

Rule 12d1-4 will generally prohibit three-tier fund-of-funds structures by imposing certain limitations on the ability of a fund that chooses to be an Acquired Fund to invest in other funds, subject to limited enumerated exceptions that are designed to capture circumstances that do not raise the fee layering and undue influence concerns underlying Section 12(d)(1) of the 1940 Act. Rule 12d1-4 only allows an Acquired Fund to invest up to 10% of its total assets in other registered funds and BDCs *and private funds*, without regard to the purpose of the investment or types of underlying funds.

We believe that Rule 12d1-4 offered the SEC an opportunity to continue the regulatory march towards the democratization of private investments. The practical impact of the three-tier fund-of-funds limit is to cut off at the knees a fast-developing product that is designed to

provide retail investors democratized access to private markets—registered funds of private funds. These products have been touted for use specifically for target date funds, which are funds of funds that provide diversified pools for investors, often in retirement plans. As an example of private market democratization, the Department of Labor recently provided ERISA plan sponsors with a road map to properly incorporate private equity investments in defined contribution plans, such as target date funds.^[7] However, these funds of private funds will be prohibited from being Acquired Funds under the new construct. Thus, target date funds that would like to invest in such funds will be limited to owning no more than 3% of any such fund. Given the relative size of the target date fund universe (very large) and the fund of private funds universe (nascent), this inclusion of the private funds limitation in the definition of Acquired Funds will be a significant headwind for the growth of this industry, a sentiment shared by other industry participants.^[8]

Beyond the unfortunate impact on funds of private funds, there are other funds that may be caught in the cross-fire of this particular provision. For example, certain entities rely on Section 3(c)(1) or 3(c)(7) and are thus private funds for purposes of the limitation on the investments of Acquired Funds, but are not private investment funds in the ordinary sense in which one thinks of private funds, *e.g.*, certain securitization vehicles such as CLOs. Debt funds with fund-of-fund investors relying on Rule 12d1-4 may inadvertently be considered a “middle tier” fund in a three-tier fund structure if they invest substantially in CLOs and other structured finance vehicles that rely on Section 3(c)(1) or 3(c)(7). This may mean, for example, that certain BDCs will be ineligible Acquired Funds, blunting some of the positive impact the Rule could have had.

While we believe that Rule 12d1-4 is beneficial to the registered fund industry in that it provides a consistent framework for all market participants, we believe there that there are several issues that we hope will be addressed in further SEC or Staff action.

^[1] Specifically, Section 12(d)(1) of the 1940 Act prohibits an Acquiring Fund from acquiring: (i) more than 3% of the voting stock of an Acquired Fund; (ii) securities issued by an Acquired Fund having an aggregate value in excess of 5% of the value of the total assets of the Acquiring Fund; or (iii) securities issued by Acquired Funds having an aggregate value in excess of 10% of the value of the total assets of the Acquiring Fund.

^[2] In order to continue to invest in the instruments currently permitted by Rule 12d1-2 after the effective date of its rescission, such funds will have to rely on Rule 12d1-4.

^[3] See Comment Letter of Parallax Volatility Advisers (May 1, 2019) (recommending that the SEC exclude private funds from the limits in Section 12(d)(1) with respect to acquiring ETFs, subject to appropriate conditions); Comment Letter of TPG Specialty Lending, Inc. (May 2, 2019) (proposing that the SEC increase the Section 12(d)(1)(A)(i) limit for private funds from 3% to 10%).

^[4] See Tailored Shareholder Reports, Treatment of Annual Prospectus Updates for Existing Investors, and Improved Fee and Risk Disclosure for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements, 1940 Act Release No. 33963 (Aug. 5, 2020). As proposed, funds that invest 10% or less of total assets in Acquired Funds would be permitted to disclose AFFE information in a footnote to the fees and expenses table instead of a separate line item.

^[5] See Commission Division of Investment Management Staff Statement on Control Share Acquisition Statutes (May 27, 2020) and Boulder Total Return Fund, SEC No-Action Letter, Nov. 15, 2010 (withdrawn).

^[6] See, *e.g.*, Comment Letter of Advent Capital Management, LLC (May 1, 2019) (encouraging the SEC to state in the Rule 12d1-4 adopting release that it would look through to underlying private fund advisory group holdings when determining Rule 12d1-4 compliance, pursuant to Section 48(a) of the 1940 Act). See also Comment Letter of the Asset Management Group of the Securities Industry and Financial Markets Association (May 2, 2019) (noting that activist firms have “taken advantage of an inadequate statutory framework” and requesting that the SEC make private fund investments in closed-end funds and BDCs subject to the same restrictions as in Section 12(d)(1)(C)).

[7] U.S. Department of Labor Information Letter from Louis J. Campagna to Jon W. Breyfogle (June 3, 2020).

[8] *See, e.g.*, Comment Letter of Fidelity Fixed Income and Asset Allocation Funds (May 2, 2019); Comment Letter of Nuveen, LLC (May 2, 2019); Comment Letter of Federal Regulation of Securities Committee of the Business Law Section of the American Bar Association (June 11, 2019).

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