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SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 270 and 274

Release Nos. 33-10871; IC-34045; File No. S7-27-18

RIN 3235-AM29

Fund of Funds Arrangements

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (the "Commission") is adopting a new rule under the Investment Company Act of 1940 ("Investment Company Act" or "Act") to streamline and enhance the regulatory framework applicable to funds that invest in other funds ("fund of funds" arrangements). In connection with the new rule, the Commission is rescinding rule 12d1-2 under the Act and certain exemptive relief that has been granted from sections 12(d)(1)(A), (B), (C), and (G) of the Act permitting certain fund of funds arrangements. Finally, the Commission is adopting related amendments to rule 12d1-1 under the Act and to Form N-CEN.

DATES: *Effective Date:* This rule is effective [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. *Compliance Dates*: The applicable compliance dates are discussed in sections II.D, II.F and III of this final rule.

FOR FURTHER INFORMATION CONTACT: Bradley Gude, Terri G. Jordan, John Lee, Adam Lovell, Senior Counsels; Jacob D. Krawitz, Branch Chief; Melissa Gainor, Brian Johnson, Assistant Directors, at (202) 551-6792, Investment Company Regulation Office, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Commission is adopting 17 CFR 270.12d1-4 (new rule 12d1-4) under the Investment Company Act [15 U.S.C. 80a-1 *et seq*.];[1] amendments to 17 CFR 270.12d1-1 (rule 12d1-1) under the Investment Company Act; amendments to Form N-CEN [referenced in 17 CFR 274.101] under the Investment Company Act; and rescission of 17 CFR 270.12d1-2 (rule 12d1-2) under the Investment Company Act.

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[1] Unless otherwise noted, all references to statutory sections are to the Investment Company Act, and all references to rules under the Investment Company Act are to title 17, part 270 of the Code of Federal Regulations [17 CFR part 270].

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I. Introduction

We are adopting new rule 12d1-4 under the Investment Company Act and several related amendments to streamline and enhance the regulatory framework applicable to fund of funds arrangements. This framework reflects the Commission's decades of experience with fund of funds arrangements and will create a consistent and efficient rules-based regime for the

formation, operation, and oversight of fund of funds arrangements.[2] We believe that this framework 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.

Funds increasingly invest in other funds as a way to achieve asset allocation, diversification, or other investment objectives. According to staff estimates, approximately 40% of all registered funds hold an investment in at least one fund,[3] and total net assets in mutual funds that invest primarily in other mutual funds have grown from $469 billion in 2008 to $2.54 trillion in 2019.[4] Retail investors similarly use fund of funds arrangements as a convenient way to allocate and diversify their investments through a single, professionally managed portfolio. For example, a fund of funds may provide an investor with the same benefits as separate direct investments in several underlying funds, without the increased monitoring and recordkeeping that could accompany investments in each underlying fund.[5]

In December 2018, we proposed rule 12d1-4, which would permit a fund to acquire shares of another fund in excess of the limits of section 12(d)(1) without obtaining an exemptive

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[2] As discussed in more detail below, section 12(d)(1) of the Investment Company Act limits the ability of a fund to invest substantially in securities issued by another fund. *See* 15 U.S.C. 80a-12(d)(1).

[3] *See infra* Table 2. Of those funds investing in other funds, 48% invest at least 5% of their assets in other funds, and 26% hold more than 90% of their assets in other funds. *See infra* Table 4. For more data on fund of funds arrangements, *see infra* section VI.

[4] During this period the number of mutual funds utilizing this arrangement grew from 838 to 1,469. *See* Investment Company Institute, 2020 Fact Book: A Review of Trends and Activities in the Investment Company Industry ("2020 ICI Fact Book"), at 244, *available at* https://www.ici.org/pdf/2020_factbook.pdf.

[5] Target-date funds are a common type of fund of funds arrangement and are designed to make it easier for investors to hold a diversified portfolio of assets that is rebalanced over time without the need for investors to rebalance their own portfolio. *See* Investment Company Advertising: Target Date Retirement Fund Names and Marketing, Investment Company Act Release No. 29301 (June 16, 2010) [75 FR 35920 (June 23, 2010)] (proposing disclosure requirements for target date retirement funds' marketing materials).

order from the Commission, subject to certain conditions.[6] Because the proposed rule would provide a comprehensive exemption for funds of funds to operate, the Commission also proposed to rescind rule 12d1-2 under the Act and individual exemptive orders permitting certain fund of funds arrangements. In connection with the proposed rescission of rule 12d1-2, we proposed amendments to rule 12d1-1 under the Act to allow funds that rely on section 12(d)(1)(G) of the Act to invest in money market funds that are not part of the same group of investment companies. Finally, the Commission proposed certain disclosure amendments to Form N-CEN to provide the Commission additional census-type information regarding fund of funds arrangements.

We received more than 100 comment letters on the proposal.[7] Many commenters supported the Commission's goal of simplifying the regulatory framework for fund of funds arrangements.[8] However, commenters recommended modifications to the proposed rule.[9] For

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6 *See* Fund of Funds Arrangements, Investment Company Act Release No. 10590 (Dec. 19, 2018) [84 FR 1286 (Feb 1, 2019)] ("2018 FOF Proposing Release"). For purposes of this release and rule 12d1-4, we generally use the term "funds" to refer to registered investment companies and business development companies ("BDCs") unless the context otherwise requires. A BDC is a closed-end fund that: (i) is organized under the laws of, and has its principal place of business in, any state or states; (ii) is operated for the purpose of investing in securities described in section 55(a)(1)-(3) of the Act and makes available "significant managerial assistance" to the issuers of those securities, subject to certain conditions; and (iii) has elected under section 54(a) of the Act to be subject to the sections addressing activities of BDCs under the Act. *See* 15 U.S.C. 80a-2(a)(48). Section 6(f) of the Act exempts BDCs that have made the election under section 54 of the Act from registration provisions of the Act.

7 The comment letters on the 2018 FOF Proposing Release (File No. S7-27-18) are available at https://www.sec.gov/comments/s7-27-18/s72718.htm.

8 *See, e.g.,* Comment Letter of Managed Funds Association (April 30, 2019) ("MFA Comment Letter"); Comment Letter of Investment Company Institute (April 30, 2019) ("ICI Comment Letter"); Comment Letter of Investment Adviser Association (May 2, 2019) ("IAA Comment Letter"); Comment Letter of Consumer Federation of America (May 2, 2019) ("CFA Comment Letter"); Comment Letter of the Asset Management Group of the Securities Industry and Financial Markets Association (May 2, 2019) ("SIFMA AMG Comment Letter"); Comment Letter of Federal Regulation of Securities Committee of the Business Law Section of the American Bar Association (June 11, 2019) ("ABA Comment Letter").

9 *See, e.g.,* ICI Comment Letter; ABA Comment Letter; SIFMA AMG Comment Letter; Comment Letter of the Committee on Investment Management Regulation of the New York City Bar Association (May 2, 2019) ("NYC Bar Comment Letter"); Comment Letter of Institute for Portfolio Alternatives (May 1, 2019) ("IPA Comment Letter"); Comment Letter of Fidelity Investments (May 2, 2019) ("Fidelity Comment

example, several commenters suggested changing the scope of arrangements permitted by the rule or expanding the scope of certain exemptions.[10] Many commenters also recommended alternatives to the proposed rule's conditions. For instance, commenters strongly opposed the proposed redemption limit and recommended instead codifying certain conditions in existing exemptive orders or applying the limitation only to unaffiliated fund of funds arrangements.[11] Several commenters recommended modifications to the proposed rule's control and voting provisions, while some commenters proposed changes to the proposed rule's disclosure and board reporting requirements.[12] Some commenters expressed concern about the potential impact of the proposed rule's conditions on existing fund of funds arrangements, particularly in light of the proposed rescission of rule 12d1-2 and existing exemptive orders.[13]

After consideration of the comments we received, we are adopting rule 12d1-4 with several modifications designed to increase the workability of the rule's requirements, while enhancing protections for investors in fund of funds arrangements. We are also rescinding rule 12d1-2 and exemptive relief that permitted certain fund of funds arrangements, amending rule 12d1-1 under the Act, and amending Form N-CEN.

A. Regulatory Context

Letter").

10 *See, e.g.,* MFA Comment Letter; NYC Bar Comment Letter; CFA Comment Letter; Comment Letter of T. Rowe Price (May 2, 2019) ("TRP Comment Letter").

11 *See, e.g.,* Comment Letter of Guggenheim Investments (May 2, 2019) ("Guggenheim Comment Letter"); Comment Letter of Dimensional Funds (May 2, 2019) ("Dimensional Comment Letter"); Comment Letter of Wells Fargo Funds Management, LLC (May 2, 2019) ("Wells Fargo Comment Letter"); Comment Letter of Federated Investors, Inc. (May 2, 2019) ("Federated Comment Letter"); SIFMA AMG Comment Letter; Fidelity Comment Letter; NYC Bar Comment Letter.

12 *See, e.g.,* MFA Comment Letter; ICI Comment Letter; IPA Comment Letter; SIFMA AMG Comment Letter; Fidelity Comment Letter; Comment Letter of PGIM Investments LLC (May 2, 2019) ("PGIM Comment Letter"); TRP Comment Letter.

13 *See, e.g.,* Comment Letter of Pacific Investment Management Company LLC (May 1, 2019) ("PIMCO Comment Letter"); Federated Comment Letter; SIFMA AMG Comment Letter; Fidelity Comment Letter; NYC Bar Comment Letter.

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

- acquiring more than 3% of another fund's outstanding voting securities;
- investing more than 5% of its total assets in any one fund; or
- investing more than 10% of its total assets in funds generally.[14]

Section 12(d)(1)(B) of the Act addresses the other side of the transaction by prohibiting a registered open-end fund,[15] and any principal underwriter thereof or broker-dealer registered under the Securities Exchange Act of 1934 (the "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.[16]

These restrictions are designed to prevent fund of funds arrangements that allow the acquiring fund to control the assets of the acquired fund and use those assets to enrich the

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[14] *See* 15 U.S.C. 80a-12(d)(1)(A). Both registered and unregistered investment companies are subject to these limits with respect to their investments in a registered investment company. Registered investment companies are also subject to these same limits with respect to their investment in an unregistered investment company. Sections 3(c)(1) and 3(c)(7) subject private funds to the 3% limitation on investments in registered funds. 15 U.S.C. 80a-3(c)(1) and 3(c)(7)(D). A "private fund" is an issuer that would be an investment company, as defined in section 3 of the Act, but for section 3(c)(1) or 3(c)(7) of the Act. 15 U.S.C. 80b-2(a)(29). In addition, section 60 of the Act makes section 12(d) applicable to a BDC to the same extent as it if were a registered closed-end fund. 15 U.S.C. 80a-60.

[15] A registered open-end fund is a management company that is offering for sale or has outstanding any redeemable security of which it is the issuer. 15 U.S.C. 80a-5(a)(1) (defining "open-end company"). A registered closed-end fund is any management company other than an open-end fund. 15 U.S.C. 80a-5(a)(2) (defining "closed-end company"). Section 12(d)(1)(C) of the Act also includes specific limitations on investments in registered closed-end funds. *See* 15 U.S.C. 80a-12(d)(1)(C).

[16] *See* 15 U.S.C. 80a-12(d)(1)(B).

acquiring fund at the expense of acquired fund shareholders.[17] Congress also was concerned about the potential for duplicative and excessive fees when one fund invested in another and the formation of overly complex structures that could be confusing to investors.[18]

As discussed in the 2018 FOF Proposing Release, our views and those of Congress have evolved over the years as fund of funds structures developed that include investor protections and serve purposes that benefit investors.[19] As a result, Congress created three statutory exceptions that permit different types of fund of funds arrangements subject to certain conditions.[20] Congress also gave the Commission authority in section 12(d)(1)(J) of the Act to exempt any person, security, or transaction, or any class or classes of transactions, from the restrictions of section 12(d)(1) if the exemption is consistent with the public interest and the protection of investors.[21]

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17 This practice is described as "pyramiding." *See* 2018 FOF Proposing Release, *supra* footnote 6, at 1287. Control could be exercised either directly (such as through the voting power of a controlling interest) or indirectly (such as coercion through the threat of large-scale redemptions). *See id*.

18 Controlling persons profited when acquiring fund shareholders paid excessive fees due to duplicative charges at both the acquiring and acquired fund levels. *See* Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, H.R. Doc. No. 136, 77th Cong., 1st Sess., at ch. 7, 2725–39, 2760–75, 2778–93, (1941) ("Investment Trust Study") and Exchange-Traded Funds, Investment Company Act Release No. 28193 (Mar. 11, 2008) [73 FR 14618 (Mar. 18, 2008)] ("2008 ETF Proposing Release"), at n. 195. *See also* 2018 FOF Proposing Release, *supra* footnote 6, at 9.

19 *See* Fund of Funds Investments, Investment Company Act Release No. 27399 (June 20, 2006) [71 FR 36640 (June 27, 2006)] ("2006 FOF Adopting Release") at n.7 and accompanying text; 2008 ETF Proposing Release, *supra* footnote 18. *See also* 2018 FOF Proposing Release, *supra* footnote 6, at 10-13.

20 *See* 15 U.S.C. 80a-12(d)(1)(E) (permitting master-feeder arrangements whereby an acquiring fund invests all of its assets in a single fund), 15 U.S.C. 80a-12(d)(1)(F) (permitting a fund to take small positions (up to 3% of another fund's securities) in an unlimited number of other funds), and 15 U.S.C. 80a-12(d)(1)(G) (permitting an open-end fund or unit investment trust ("UIT") to invest in other open-end funds and UITs that are in the "same group of investment companies").

21 *See* National Securities Markets Improvement Act of 1996 ("NSMIA"), Pub. L. No. 104-290, 110 Stat. 3416 (1996), at § 202(4) (codified at 15 U.S.C. 80a-12(d)(1)(J)); Comm. On Commerce, Securities Amendments of 1996, H.R. Rep. No. 104-622 (1996), 104th Cong., 2nd Sess., at 43-44 ("H.R. Rep. No. 622"). Congress added section 12(d)(1)(J) to resolve questions regarding the scope of the Commission's authority under section 6(c) of the Act.

We previously exercised this exemptive authority to adopt three rules of general applicability that were based on relief we provided to specific market participants in exemptive orders.[22] We also have used our authority under section 12(d)(1)(J) to issue exemptive orders permitting fund of funds arrangements that the Act or our rules would otherwise prohibit when we found those arrangements to be consistent with the public interest and the protection of investors.[23] These exemptive orders permit fund investments in other funds, subject to specified conditions that are designed to prevent the abuses that led Congress to enact section 12(d)(1).[24] Relief from sections 12(d)(1)(A) and (B) was included in exemptive orders permitting exchange-traded funds ("ETFs") and exchange-traded managed funds ("ETMFs") to operate.[25]

The combination of statutory exemptions, Commission rules, and exemptive orders has created a regulatory regime where substantially similar fund of funds arrangements are subject to different conditions. For example, an acquiring fund could rely on section 12(d)(1)(G) and rule

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22 *See* 2006 FOF Adopting Release, *supra* footnote 19. Rule 12d1-1 allows funds to invest in shares of money market funds in excess of the limits of section 12(d)(1). Rule 12d1-2 provides funds relying on section 12(d)(1)(G) with greater flexibility to invest in other types of securities. Rule 12d1-3 allows acquiring funds relying on section 12(d)(1)(F) to charge sales loads greater than 1.5%.

23 As the orders are subject to terms and conditions set forth in the applications requesting exemptive relief, references in this release to "exemptive relief" or "exemptive orders" include the terms and conditions described in the related applications. *See, e.g.,* Schwab Capital Trust, *et al*., Investment Company Act Release Nos. 24067 (Oct. 1, 1999) [64 FR 54939 (Oct. 8, 1999)] (notice) and 24113 (Oct. 27, 1999) (order) and related application ("Schwab"). In addition to our section 12(d)(1)(J) authority, we have issued these orders pursuant to our exemptive authority under sections 17(a) and 6(c) of the Act.

24 The conditions include: (i) limits on the control and influence an acquiring fund can exert on the acquired fund; (ii) limits on certain fees charged to the acquiring fund and its shareholders; and (iii) limits on the acquired fund's ability to invest in other funds. *See* Schwab, *supra* footnote 23.

25 We recently adopted rule 6c-11, which permits certain ETFs to operate without obtaining an exemptive order. 17 CFR 270.6c-11. In adopting rule 6c-11, we did not rescind the portions of existing ETF exemptive orders that provided relief from sections 12(d)(1)(A) and (B) and stated that ETFs relying on rule 6c-11 that do not have exemptive relief from sections 12(d)(1)(A) and (B) may enter into fund of funds arrangements as set forth in recent ETF exemptive orders, provided that such ETFs satisfy the terms and conditions for fund of funds relief in those orders. Exchange-Traded Funds, Investment Company Act Release No. 33646 (Sep. 25, 2019) [84 FR 57162 (Oct. 24, 2019)] ("2019 ETF Adopting Release"), at 57199. For purposes of this release, we generally use the term "ETFs" to refer to exchange-traded funds and exchange-traded managed funds unless the context otherwise requires.

12d1-2 when investing in an acquired fund within the same group of investment companies.[26] 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. Over time, industry participants have experimented with new fund of funds structures, relying on combinations of statutory exemptions and Commission exemptive orders, and considering staff no-action letters, to create novel fund of funds arrangements. For example, some commenters described funds that have combined various forms of section 12(d)(1) relief to create fund structures that include three or more layers of funds.[27]

B. Rule 12d1-4 Overview

In order to create a more consistent and efficient regulatory framework for fund of funds arrangements, rule 12d1-4 will permit a registered investment company or business development company ("BDC") (collectively, "acquiring funds") to acquire the securities of any other registered investment company or BDC (collectively, "acquired funds") in excess of the limits in section 12(d)(1), subject to the following conditions:

- *Control*. Rule 12d1-4 will prohibit an acquiring fund and its "advisory group" from controlling an acquired fund, except in certain limited circumstances.
- *Voting*. Rule 12d1-4 will require an acquiring fund and its advisory group to use mirror voting if it holds more than 25% of an acquired open-end fund or UIT due

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[26] Such a fund would rely on section 12(d)(1)(G) to invest in acquired funds within the same group of investment companies, government securities, and short term paper. In addition, the fund could rely on rule 12d1-2 to invest in: (i) securities of funds that are not in the same group of investment companies up to the limits in section 12(d)(1)(A) or (F); (ii) securities of money market funds in reliance on rule 12d1-1; and (iii) stocks, bonds, and other securities.

[27] *See, e.g.,* Fidelity Comment Letter; Federated Comment Letter; Comment Letter of Federated Investors, Inc. (June 7, 2019) ("Federated 2 Comment Letter").

to a decrease in the outstanding securities of the acquired fund and if it holds more than 10% of a closed-end fund, with the ability to use pass-through voting when acquiring funds are the only shareholders of an acquired fund.[28]

- *Required 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. The final rule also will require certain findings with respect to UITs and separate accounts funding variable insurance contracts, taking into account the unique structural characteristics of such entities.
- *Fund of Funds Investment Agreement*. 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 (a "fund of funds investment agreement").
- *Complex Structures*. Rule 12d1-4 will impose a general three-tier prohibition with certain enumerated exceptions. However, in addition to these exceptions, the rule 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.

As proposed, we are rescinding rule 12d1-2 under the Act, and amending rule 12d1-1 to allow funds that rely on section 12(d)(1)(G) to invest in money market funds that are not part of the same group of investment companies in reliance on that rule.[29] In addition, certain staff no-

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[28] *See infra* section II.C.1.b.ii.

[29] With the rescission of rule 12d1-2, a fund relying on section 12(d)(1)(G) will no longer have flexibility to:

action letters relating to section 12(d)(1) will be withdrawn.[30] The resulting regulatory framework will reduce confusion and subject similar fund of funds arrangements to tailored conditions that will enhance investor protection, while continuing to provide funds with investment flexibility to meet their investment objectives. In addition, the rule will allow the Commission, as well as funds and advisers seeking exemptions, to focus exemptive order review resources on novel products or arrangements.

II. Discussion

A. Scope

1. Registered Funds and BDCs

As proposed, rule 12d1-4 will permit registered investment companies and BDCs to acquire the securities of other registered investment companies or BDCs in excess of the limits in section 12(d)(1). As a result, open-end funds (including ETFs), UITs (including ETFs organized as UITs), and closed-end funds (including BDCs), can operate in accordance with rule 12d1-4, as both acquiring and acquired funds.[31] The scope of permissible acquiring and acquired funds under rule 12d1-4 is greater than the scope of funds that was permitted by the Commission's exemptive orders. For example, the rule will allow open-end funds, UITs, and ETFs to invest in

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(i) acquire the securities of other funds that are not part of the same group of investment companies; or (ii) invest directly in stocks, bonds, and other securities, except in compliance with rule 12d1-4.

30 The list of no-action letters to be withdrawn will be available on the Commission's website.

31 As proposed, the final rule will not be available to face-amount certificate companies. Face-amount certificate companies are registered investment companies that are engaged or propose to engage in the business of issuing face-amount certificates of the installment type, or which have been engaged in such businesses and have any such certificates outstanding. *See* section 4(1) of the Investment Company Act. There is only one face-amount certificate company currently operating as an investment company and making current filings pursuant to section 13 [15 U.S.C. 80a-13] or section 15(d) of the Exchange Act [15 U.S.C. 80a-15]. Given the very limited universe of face-amount certificate companies and the nature of their investments, face-amount certificate companies are not within the scope of final rule 12d1-4 as either acquiring funds or acquired funds. No commenters addressed this aspect of the proposal.

unlisted closed-end funds and unlisted BDCs beyond the limits in section 12(d)(1).[32] The rule similarly will increase permissible investments for closed-end funds beyond ETFs to allow them to invest in open-end funds, UITs, other closed-end funds, and BDCs, in excess of the section 12(d)(1) limits. BDCs, which currently may invest in ETFs in excess of the section 12(d)(1) limits, also will be permitted to invest in open-end funds, UITs, other BDCs, other closed-end funds and ETMFs. Finally, the rule will allow ETMFs to invest in open-end funds, UITs, BDCs and other closed-end funds. Rule 12d1-4, therefore, will create a consistent framework for all registered funds and BDCs and eliminate unnecessary and potentially confusing distinctions among permissible investments for different types of acquiring funds.

Several commenters supported including all open-end funds, UITs, BDCs and other closed-end funds within the scope of permissible fund of funds arrangements under the rule.[33] The commenters noted that proposed rule 12d1-4 would provide funds covered by the rule with flexibility to meet their investment objectives and level the playing field among registered funds and BDCs operating in accordance with the rule. However, one commenter raised concerns with arrangements that the Commission has not previously permitted in exemptive orders.[34] This commenter stated that the Commission lacks experience with funds of funds arrangements that include unlisted closed-end funds and BDCs and suggested that permitting these funds to rely on the rule as acquired funds would increase retail investor exposure to higher cost investments.

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[32] We use the terms "listed closed-end funds" and "listed BDCs" to refer to closed-end funds and BDCs that are listed and traded on national securities exchanges. Our exemptive orders have included a representation that acquiring funds will not invest in reliance on the order in closed-end funds or BDCs that are not listed and traded on a national securities exchange. *See, e.g.*, Innovator ETFs Trust, et al., Investment Company Act Release Nos. 33214 (Aug. 24, 2018) [83 FR 44374 (Aug. 30, 2018)] (notice) and 33238 (Sept. 19, 2018) (order) and related application ("Innovator ETFs").

[33] *See, e.g.*, ICI Comment Letter; Comment Letter of Morningstar, Inc. (May 2, 2019) ("Morningstar Comment Letter").

[34] *See* CFA Comment Letter.

The commenter also questioned whether one rule should apply to all types of fund of funds arrangements, noting that several of the statutory requirements of section 12(d)(1) apply differently to open-end funds and closed-end funds, and the Commission's historical exemptive relief also treated these types of funds differently. The commenter additionally questioned whether the Commission has appropriately analyzed the risks of fund of funds arrangements involving ETMFs or "non-transparent" ETFs.

After considering these comments, we continue to believe that the universe of permissible fund of funds arrangements generally should not turn on the type of funds in the arrangement. Instead, the rule should address differences in fund structures with tailored conditions that protect investors in all types of covered investment companies against the abuses historically associated with funds of funds. We believe the conditions of rule 12d1-4 provide appropriate flexibility for innovative fund of funds structures while creating a consistent and streamlined regulatory framework that protects investors in all types of funds. For example, for a management company to rely on the rule, the investment advisers to both the acquiring and acquired fund must make certain determinations before entering into the fund of funds arrangement.[35] Similarly, the rule will also require principal underwriters or depositors of UITs and insurance companies offering certain separate accounts to make findings tailored to their characteristics.[36] The rule also imposes a requirement that certain acquiring funds and acquired funds enter into a fund of funds investment agreement, and imposes voting requirements on

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[35] *See infra* section II.C.2.b.i.

[36] *See infra* section II.C.2.b.ii. For example, UITs do not have a board of directors and do not engage in active management of a portfolio. The rule therefore will require different determinations for UITs.

acquiring funds' holdings of acquired funds above certain ownership thresholds that differ depending on the type of acquired fund, as described more fully below.[37]

With respect to BDCs, we believe that the rule's conditions and existing statutory provisions will protect investors from concerns related to undue influence, fees that are excessive due to being duplicative, or complex structures. For example, as we noted in the proposal, an acquiring fund board already has a responsibility to see that the fund is not overcharged for advisory services regardless of any findings we require.[38] Additionally, the rule will require fund of funds arrangements involving BDCs to satisfy the other conditions of rule 12d1-4, including the requirement to make certain findings as described in section II.C.2.b. below. One element of these findings is a determination that the fees and expenses associated with an investment in an acquired fund, including an investment in an acquired BDC, do not duplicate the fees and expenses of the acquiring fund. Further, a BDC operating in accordance with the rule as an acquiring fund is subject to other existing limitations on its ability to invest in acquired funds.[39]

Similarly, we do not believe that including ETMFs or non-transparent ETFs within the scope of the rule will present unique investor protection concerns that we have not already extensively considered and addressed with respect to traditional registered open-end funds and

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[37] *See infra* sections II.C.1 and 2.

[38] Specifically, section 15(c) of the Act requires the acquiring fund's board of directors to evaluate any information reasonably necessary to evaluate the terms of the acquiring fund's advisory contracts (which information would include fees, or the elimination of fees, for services provided by an acquired fund's adviser). Section 36(b) of the Act imposes on fund advisers a fiduciary duty with respect to their receipt of compensation. We believe that to the extent advisory services are being performed by another person, such as the adviser to an acquired fund, this fiduciary duty would require an acquiring fund's adviser to charge a fee that bears a reasonable relationship only to the services that the acquiring fund's adviser is providing, and not to any services performed by an adviser to an acquired fund. *See* 2018 FOF Proposing Release, *supra* footnote 6, at 63-64.

[39] *See* 15 U.S.C. 80a-54(a) (prohibiting a BDC from making any investment unless, at the time of the investment, at least 70% of the BDC's total assets are invested in securities of certain specific types of companies, which do not include funds).

fully transparent ETFs. Along with fully transparent ETFs, ETMFs and non-transparent ETFs generally are subject to the protections of the Act applicable to all registered open-end funds, including governance and other requirements. Accordingly, we believe that the conditions of rule 12d1-4, when combined with the protections imposed by the Act on all investment companies, appropriately address concerns of duplicative fees, undue influence, and complex structures with respect to these products.

Finally, one commenter suggested that the concerns underlying section 12(d)(1) of the Act largely do not apply to ETFs as acquired funds in a fund of funds structure.[40] This commenter stated that passive investments in ETFs do not implicate Congress' concerns regarding duplicative fees and undue influence, particularly when an investor holds an ETF to gain exposure to a particular market or asset class in an efficient manner, to allocate and diversify investments, or efficiently hedge a portion of a portfolio or balance sheet. The commenter stated that ETFs have not been subject to influence from activist investors despite ETF shares trading in the secondary market, perhaps because ETF shares have not historically traded at a significant discount to net asset value. Accordingly, the commenter urged the Commission to exempt the sale of ETFs as acquired funds from the limitations in section 12(d)(1)(B) of the Act.

After considering comments, we continue to believe that investments in ETFs should be subject to the limitations set forth in section 12(d)(1), and that any investments in excess of the 12(d)(1) limits should be subject to protective conditions. As a threshold matter, ETFs issue

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[40] Comment Letter of WisdomTree Asset Management, Inc. (Dec. 12, 2019) ("WisdomTree Comment Letter").

redeemable securities and are generally classified as open-end funds under the Act.[41] As we discussed in our 2008 ETF Proposing Release, we believe that investments in ETFs, similar to investments in traditional open-end funds, raise the same concerns of pyramiding and the threat of large-scale redemptions as other types of open-end funds.[42] For example, an acquiring fund might seek to use its ownership interest in an ETF to exercise a controlling influence over the ETF's management or policies, or to enter into a transaction with an affiliate of the acquiring fund. These concerns are most pronounced when a fund invests in an ETF in a primary market transaction through an authorized participant.[43]

ETFs, like other open-end funds, also operate pursuant to the prohibition in section 12(d)(1)(B), which provides that it is unlawful knowingly to sell or otherwise dispose of any securities of which the ETF is an issuer to any other investment company in excess of the limits in subsection (i) and (ii). Therefore, ETFs that receive inquiries and other communications from persons identifying themselves as potential purchasers of the ETF's shares as or through an authorized participant may want to consider adopting and implementing policies and procedures to determine whether those persons intend to purchase ETF shares for investment companies.[44] Further, principal underwriters and broker-dealers that transact in an ETF's shares

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41 While most ETFs are classified as open-end funds, some ETFs are structured as UITs. Regardless of structure, we do not believe that the redemption of ETF shares in creation unit-sized aggregations by authorized participants insulates ETFs from the abuses that section 12(d)(1) was designed to prevent.

42 *See* 2008 ETF Proposing Release, *supra* footnote18, at 69.

43 *See generally* 2019 ETF Adopting Release, *supra* footnote 25, at section I.B (explaining that an authorized participant that has a contractual arrangement with the ETF (or its distributor) purchases and redeems ETF shares directly from the ETF in blocks called "creation units" as a principal for its own account or as agent for others, including institutional investors (such as funds)).

44 For example, an ETF that explains its obligations pursuant to section 12(d)(1)(B) to potential purchasers who reach out directly to the ETF, and documents that exchange with the potential purchaser, generally would satisfy its obligation not to knowingly sell or otherwise dispose of any of its securities in excess of 12(d)(1)(B) limits. Further, if an ETF intends to rely on rule 12d1-4 to exceed the section 12(d)(1) limits, such ETF would be required to comply with the conditions of the rule, including entering into a fund of funds investment agreement with the acquiring investment company.

(including an ETF's authorized participants), are subject to the requirements of section 12(d)(1)(B) of the Act. Accordingly, the final rule will treat ETFs consistently with other open-end funds and will permit investments in ETFs as acquired funds subject to the rule's conditions designed to protect acquired funds and their shareholders.

2. Private Funds and Unregistered Investment Companies

As proposed, the final rule will not permit private funds and unregistered investment companies, such as foreign funds, to rely on the rule as acquiring funds.[45] As a result, private funds and unregistered investment companies may acquire no more than 3% of a U.S. registered fund under the Act.[46]

Several commenters suggested that the Commission broaden the scope of rule 12d1-4 to permit investments by private funds or unregistered investment companies in acquired funds beyond the limits in section 12(d)(1).[47] Some of these commenters highlighted the potential for private and unregistered investment companies to invest in registered funds for efficient allocation, diversification, and hedging purposes and stated that such investments could benefit registered fund shareholders by increasing the scale and liquidity of the registered fund.[48]

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[45] We use the term "foreign fund" to refer to an "investment company" as defined in section 3(a)(1)(A) of the Act that is organized outside the United States and that does not offer or sell its securities in the United States in connection with a public offering. *See* section 7(d) of the Act (prohibiting a foreign fund from using the U.S. mails or any means or instrumentality of interstate commerce to offer or sell its securities in connection with a public offering unless the Commission issues an order permitting the foreign fund to register under the Act). A foreign fund may conduct a private U.S. offering in the United States without violating section 7(d) of the Act if the foreign fund conducts its activities with respect to U.S. investors in compliance with either section 3(c)(1) or 3(c)(7) of the Act (or some other available exemption or exclusion). *See* 2018 FOF Proposing Release, *supra* footnote 6, at 18-20.

[46] Sections 3(c)(1) and 3(c)(7) of the Act subject private funds to the 3% limitation on investments in registered funds. 15 U.S.C. 80a-3(c)(1) and 3(c)(7)(D).

[47] *See, e.g.,* ICI Comment Letter; Comment Letter of American Investment Council (May 2, 2019) ("AIC Comment Letter"); Comment Letter of Dechert LLP (May 2, 2019) ("Dechert Comment Letter"); Comment Letter of Clifford Chance US LLP (May 2, 2019) ("Clifford Chance Comment Letter"); NYC Bar Comment Letter; IAA Comment Letter; ABA Comment Letter.

[48] *See* MFA Comment Letter; Comment Letter of BlackRock, Inc. (May 3, 2019) ("BlackRock Comment

Commenters that supported broadening the scope of the rule to include private funds and unregistered investment companies stated that such funds do not operate in a materially different manner from registered funds and therefore the concerns underlying section 12(d)(1) are not any more pronounced for private and unregistered investment companies nor are different conditions warranted.[49]

While commenters generally suggested subjecting private funds and unregistered investment companies to the same conditions as other acquiring funds, some commenters recommended additional conditions that could apply to private funds and unregistered investment companies under the rule.[50] For example, commenters suggested that the rule could include recordkeeping and reporting requirements tailored to private funds and unregistered investment companies or limit the availability of the rule to private funds and unregistered investment companies with an adviser that is registered with the Commission.[51] Some commenters suggested that the final rule allow private funds and unregistered investment

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Letter") (stating "ETFs are also frequently used as an alternative to futures and other market beta instruments such as forwards and swaps, especially in markets where derivatives may be less liquid or nonexistent, because ETFs offer intraday liquidity"); WisdomTree Comment Letter; NYC Bar Comment Letter.

49 Comment Letter of Invesco Ltd. (Apr. 30, 2019) ("Invesco Comment Letter"); MFA Comment Letter; ICI Comment Letter; Dechert Comment Letter; Comment Letter of Parallax Volatility Advisers, L.P. (May 1, 2019) ("Parallax Comment Letter"); Comment Letter of Gracie Asset Management (May 2, 2019) ("Gracie Comment Letter"); AIC Comment Letter; IAA Comment Letter; Comment Letter of Ropes & Gray LLP (May 2, 2019) ("Ropes Comment Letter"). One commenter stated that fee layering and complex structure concerns are not as significant in the private fund context as they are in the registered fund context because private fund investors must meet sophistication standards and typically perform due diligence on a private fund's structure and fees. Comment Letter of Massachusetts Mutual Life Insurance Company (May 2, 2019).

50 Some commenters stated that certain private funds have sought to control closed-end funds that trade at a discount to their NAV and suggested tailored control and voting conditions if private funds could rely on the rule to invest in closed-end funds and BDCs. *See* AIC Comment Letter; SIFMA AMG Comment Letter. *See also infra* section II.C.1.a.ii.

51 Invesco Comment Letter; MFA Comment Letter; ICI Comment Letter; Gracie Comment Letter; AIC Comment Letter; BlackRock Comment Letter; Clifford Chance Comment Letter; NYC Bar Comment Letter; IAA Comment Letter; ABA Comment Letter.

companies to invest in only certain types of funds, such as ETFs, subject to appropriate conditions.[52]

Other commenters recommended that the rule exclude unregistered investment companies as acquiring funds because the Commission has not yet extended exemptive relief allowing such funds to acquire other investment companies in excess of the section 12(d)(1) limits.[53] These commenters stated that the Commission does not have experience with this type of fund of funds arrangement, and recommended that the Commission first provide relief to unregistered investment companies through the exemptive application process. These commenters suggested that this process would allow the Commission to weigh the facts and circumstances of each particular applicant, and the type of underlying fund in the proposed fund of funds arrangement. Two commenters recommended that the rule exclude private funds as acquiring funds because of concerns of undue influence over closed-end funds.[54]

After considering comments, we continue to believe that the rule should not include private funds and unregistered investment companies as acquiring funds. We acknowledge that permitting private funds and unregistered investment companies to rely on the rule as acquiring funds would provide these funds greater investment flexibility, and would increase the scale of U.S. registered funds that were acquired by private funds and unregistered investment companies. However, we do not have sufficient experience tailoring conditions for private

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52 *See, e.g.*, BlackRock Comment Letter; Parallax Comment Letter; MFA Comment Letter (stating that the Commission has already allowed private funds to invest in money market funds beyond the limits of section 12(d)(1) of the Investment Company Act in rule 12d1-1, and that secondary market transactions in ETFs may be less likely to raise certain abuses that section 12(d)(1) was designed to prevent).

53 *See* Comment Letter of Kauff Laton Miller LLP (May 13, 2019) ("Kauff Comment Letter"); Comment Letter of Law Office of William Coudert Rand (May 14, 2019) ("Rand Comment Letter"); Comment Letter of Cooper LLC (May 24, 2019) ("Cooper Comment Letter").

54 Comment Letter of Advent Capital Management, LLC (May 1, 2019 ("Advent Comment Letter"); Comment Letter of FS Investments (May 2, 2019) ("FS Comment Letter").

funds' and unregistered investment companies' investments in registered funds to address in a rule of general applicability the concerns such funds present as acquiring funds, as described below. To date, few applicants have requested relief to permit private funds or unregistered investment companies to invest in registered funds beyond the limits in section 12(d)(1) of the Act.[55]

We believe it would be more appropriate to consider designing protective conditions through the exemptive application process because including private funds and unregistered investment companies as acquiring funds raises different concerns. Private funds and unregistered investment companies are not registered with the Commission, and their investments in registered funds would not be subject to the reporting requirements under the Act. In particular, private funds and unregistered investment companies are not subject to periodic reporting on Form N-PORT or the new reporting requirements that we are adopting on Form N-CEN regarding reliance on rule 12d1-4.[56]

Additionally, while several commenters noted that many advisers to private funds are required to disclose census-type information about their private funds on Form PF, Form PF does not require advisers to disclose the position-level information that would allow us to monitor

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[55] The exemptive application process provides an opportunity to consider tailored conditions and limitations for a specific applicant that seeks relief to permit private funds or unregistered investment companies to invest in registered funds beyond the limits in section 12(d)(1) of the Act. If granted, the Commission and its staff could monitor fund of funds arrangements that operate pursuant to such exemptive relief, determine whether the conditions and limitations of the relief operate as intended, and consider whether further rulemaking may be appropriate.

[56] Form N-PORT requires certain registered funds to report information about their monthly portfolio holdings to the Commission in a structured data format. *See* Investment Company Reporting Modernization, Investment Company Act Release No. 32314 (Oct. 13, 2016) [81 FR 81870 (Nov. 18, 2016)] ("Reporting Modernization Adopting Release"). Rule 31a-1 under the Act sets forth certain other recordkeeping requirements for registered investment companies.

compliance with rule 12d1-4 and its impact on the fund industry.[57] In addition, smaller private fund advisers are not required to file Form PF. Accordingly, under the existing regulatory framework, the Commission does not receive routine reporting on the amount and duration of private fund or unregistered investment company investments in registered funds. As noted in the 2018 FOF Proposing Release, even if private funds and unregistered investment companies provided basic reporting on investments in underlying funds, that reporting alone may not provide an adequate basis to protect against undue influence and monitor compliance with the rule's conditions.[58]

Private funds and unregistered investment companies are not subject to many of the governance and compliance requirements of the Act that are designed to protect investors and reduce conflicts of interest that are inherent in a fund structure. Such requirements are integral to the oversight and monitoring provisions of rule 12d1-4 for registered funds. For example, private funds and unregistered investment companies are not subject to the board governance requirements of sections 10 and 16 of the Act and the chief compliance officer requirements of rule 38a-1.[59] We are adopting rule 12d1-4 against the background of these existing requirements

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57 *See* AIC Comment Letter (noting that the Commission could consider amending Form PF to require an adviser to report if any of the private funds they advise relied on the rule during the reporting period); Clifford Chance Comment Letter; NYC Bar Comment Letter; ABA Comment Letter; Invesco Comment Letter; Parallax Comment Letter; Gracie Comment Letter. *See also* 17 CFR 275.204(b)-1 (requiring certain registered investment advisers to private funds to file Form PF to report information about the private funds they manage).

58 2018 FOF Proposing Release, *supra* footnote 6, at 20.

59 To protect shareholders and address conflicts of interest that can arise from the management of investment companies, the Act requires that a registered management investment company be governed by a board of directors that has a general oversight role, with certain exceptions. Rule 12d1-4 requires the adviser to an acquiring fund or acquired fund to submit reports to such fund's board of directors so that the board can review the adviser's analysis of the fund of funds arrangement. While UITs are not subject to these governance and oversight requirements, a UIT does not engage in active management of its investment portfolio. Accordingly, we believe that a UIT's investment in an acquired fund presents different concerns than an investment by a private fund or unregistered fund. Rule 38a-1 requires a fund (including a UIT) to adopt and implement written policies and procedures reasonably designed to prevent a violation of the

and the protections they provide for shareholders in a fund of funds arrangement. Without incorporating additional governance and compliance obligations for private funds and unregistered investment companies as acquiring funds, we do not believe rule 12d1-4 would have sufficiently protective conditions to address the undue influence concerns that Congress raised with respect to fund of funds arrangements.

We believe designing such protective conditions through the exemptive application process would allow the Commission to weigh the policy considerations described above in the context of the facts and circumstances of the specific fund of funds arrangement described in the application. The exemptive application process would allow the Commission to consider appropriate investor protection provisions, including governance and reporting requirements, applicable to any such arrangement.[60] The exemptive application process also would provide the Commission with an opportunity to analyze the operation and effects of these fund of funds arrangements before determining whether and how to address such arrangements in a rule of general applicability. We encourage interested parties to share their views on such arrangements by contacting staff in the Division of Investment Management.

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federal securities laws by the fund and designate one individual responsible for administering the fund's policies and procedures as a chief compliance officer. *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (Dec. 17, 2003) [68 F.R. 74714 (Dec. 24, 2003)] ("Compliance Rule Adopting Release"). Under rule 38a-1, a fund would adopt policies and procedures reasonably designed to prevent a violation of rule 12d1-4.

60 One commenter pointed to rule 12d1-1 as a model for private fund investments in registered funds. Prior to the adoption of that rule, the Commission considered specific proposals for exemptive relief for certain private funds to invest in affiliated money market funds. *See, e.g.,* Scudder Global Fund, Inc., *et al.*, Investment Company Act Release Nos. 24276 (Feb. 3, 2000) [65 FR 6420 (Feb. 9, 2000)] (notice) and 24322 (Feb. 29, 2000) (order) and related application; Pioneer America Income Trust, *et al.*, Investment Company Act Release Nos. 25607 (Jun. 7, 2002) [97 FR 40757 (Jun. 13, 2002)] (notice) and 25647 (Jul. 3, 2002) (order) and related application. However, the Commission has not yet granted relief for private funds to invest in registered funds in excess of the limits of section 12(d)(1) of the Act.

In addition to the challenges applicable to unregistered funds generally, foreign fund investments in registered funds present additional concerns.[61] Specifically, the Commission understands that some foreign laws and regulations may limit or prevent disclosure of information to the Commission.[62] These types of restrictions may include privacy laws and so-called "blocking statutes" (including secrecy laws) that prevent the disclosure of information relating to third parties and/or disclosure to the U.S. government.[63] Additionally, abusive practices by unregistered investment companies that were associated with such investments were a concern underlying Congress's amendments to section 12(d)(1) in 1970.[64] For example, a Commission report stated that unregistered investment companies could seek to redeem large holdings in acquired funds due to the instability of certain foreign economies, political upheaval, or currency reform.[65] The Commission also noted that an unregistered investment company

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61 The Commission has stated that a foreign fund that uses U.S. jurisdictional means in the offering of the securities it issues and that relies on section 3(c)(1) or 3(c)(7) of the Investment Company Act would be a private fund. *See* 2018 FOF Proposing Release, *supra* footnote 6, at n.52 (citing Dechert LLP, Staff No-Action Letter (Aug. 24, 2009) at n.8 (noting that under certain circumstances, a foreign fund may make a private U.S. offer in reliance on the exclusion from the definition of "investment company" in sections 3(c)(1) or 3(c)(7) of the Act, and such a foreign fund is subject to section 12(d)(1) to the same extent as a U.S. 3(c)(1) or 3(c)(7) fund)).

62 *See* Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers, Exchange Act Release No. 87005 (Sep. 19, 2019) [84 FR 68550 (Dec. 16, 2019)], at 68557.

63 *Id*. Data protection, privacy, confidentiality, bank secrecy, state secrecy, and national security laws frequently create obstacles to cross-border flows of information between regulators and foreign-domiciled registrants. Some of these laws, for example, prohibit foreign-domiciled registrants in certain jurisdictions from responding directly to SEC requests for information and documents or prevent the SEC from being able to conduct any type of examination, either onsite or by correspondence. *See* Statement on the Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally—Discussion of Current Information Access Challenges with Respect to U.S.-listed Companies with Significant Operations in China, SEC Chairman Jay Clayton, SEC Chief Accountant Wes Bricker, and PCAOB Chairman William D. Duhnke III (Dec. 7, 2018) *available at* https://www.sec.gov/news/public-statement/statement-vital-role-audit-quality-and-regulatory-access-audit-and-other.

64 *See* 2018 FOF Proposing Release, *supra* footnote 6, at 21, *citing Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth*, H.Rep. No. 2337, 89th Cong., 2d Sess. (1966) ("PPI Report") at 318.

65 PPI Report, *supra* footnote 64, at 315.

could seek to exert undue influence through the shareholder voting process.[66] For these reasons, we also do not believe it is appropriate at this time to include foreign funds in the scope of acquiring funds under rule 12d1-4.

B. Exemptions from the Act's Prohibition on Certain Affiliated Transactions

As proposed, rule 12d1-4 will provide an exemption from section 17(a) of the Act.[67] In addition, the final rule will provide a limited exemption from that section for in-kind transactions for certain affiliated persons of ETFs. Section 17(a) of the Act 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.[68] It is designed to prevent affiliated persons from managing the fund's assets for their own benefit, rather than for the benefit of the fund's shareholders.[69]

Absent 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

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66 *Id*. at 324.

67 *See* rule 12d1-4(a); 15 U.S.C. 80a-17(a). With respect to BDCs, the rule provides an exemption from sections 57(a)(1)-(2) and 57(d)(1)-(2) of the Act for arrangements that comply with rule 12d1-4. *See* 15 U.S.C. 80a-56(a)(1)-(2) and 80a-56(d)(1)-(2). The Commission proposed rule 12d1-4(a) to provide an exemption from section 57 for BDCs complying with the rule, but did not specify the relevant subsections in section 57 that are analogous to section 17(a). *See generally* proposed rule 12d1-4(a) (providing an exemption from section 57 of the Act). We did not receive comments on this aspect of the proposal. We are adopting rule 12d1-4(a) with changes to clarify and specify the relevant subsections of section 57.

68 An affiliated person of a fund includes: (i) any person directly or indirectly owning, controlling, or holding with power to vote, 5% or more of the outstanding voting securities of the fund; and (ii) any person 5% or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote by the fund. *See* 15 U.S.C. 80a-2(a)(3)(A), (B). Section 17(a) also restricts certain transactions involving funds that are affiliated because both funds have a common investment adviser or other person exercising a controlling influence over the management or policies of the funds. *See* 15 U.S.C. 80a-2(a)(3)(C). The determination of whether a fund is under the control of its advisers, officers, or directors depends on all the relevant facts and circumstances. *See infra* section II.C.1.

69 *See* Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. On Banking and Currency, 76th Cong., 3rd Sess. 37 (1940) (Statement of Commissioner Healy).

the efficacy of rule 12d1-4.[70] Fund of funds arrangements involving funds that are part of the same group of investment companies or that have the same investment adviser (or affiliated investment advisers) also implicate the Act's protections against affiliated transactions, regardless of whether an acquiring fund exceeds the 5% threshold, though the rule as adopted will not address all of these situations.[71]

Section 17(b) of the Act authorizes the Commission to exempt a proposed transaction from the provisions of section 17(a) if the terms of the transaction, including the consideration to be paid or received, are fair and reasonable and do not involve overreaching on the part of any person concerned, and the transaction is consistent with the policy of the investment company as recited in the fund's registration statement and the general purposes of the Act.[72] We continue to believe, as discussed in the 2018 FOF Proposing Release, that these exemptions from section 17(a) meet the standards set forth in sections 17(b) and 6(c) and the rule's conditions make

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[70] If an acquiring fund holds 5% or more of the outstanding voting shares of an acquired fund, the acquiring fund is an affiliated person of the acquired fund and the acquired fund is an affiliated person of the acquiring fund. In general, to the extent that purchases and sales of acquired fund shares occur on the secondary market and not through principal transactions directly between an acquiring fund and an acquired fund, an exemption from section 17(a) would not be necessary. But, generally, without an exemption from section 17(a), an acquired fund could not sell its shares to, or redeem or repurchase those shares from, an affiliated acquiring fund, and an acquiring fund could not purchase from, redeem, or resell shares from an affiliated acquired fund.

[71] As discussed below, the rule will allow fund of funds arrangements when: (i) the acquiring fund is in the same group of investment companies as the 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. *See infra* section II.C.1. However, as discussed further below, the final rule will not exempt from section 17(a) ETF in-kind creations and redemptions involving certain affiliates.

[72] Section 6(c) of the Act permits the Commission to exempt any person, security, or transaction or any class or classes of persons, securities or transactions from any provision of the Act if such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act. *See* 15 U.S.C. 6(c). The Commission has interpreted its authority under section 17(b) as extending only to a single transaction and not a series of transactions. *See* In re Keystone Custodian Funds, Inc., 21 S.E.C. 295 (1945) (exempting, under section 6(c) of the Act, a series of transactions that otherwise would be prohibited by section 17(a)). The Commission's exemptive authority under section 6(c), however, is not constrained to a single transaction. The Commission looks to the standards set forth in section 17(b) when issuing exemptions by rule from section 17(a).

unlikely the prospect of overreaching by an affiliated fund. For example, the rule prohibits the acquiring fund and its advisory group from controlling the acquired fund, which is designed to prevent a fund of funds arrangement that involves overreaching.

An acquired fund that is an open-end fund or UIT also is protected from overreaching due to the Act's requirement that all purchasers receive the same price.[73] This ensures that the affiliated person pays the same consideration for fund shares as non-affiliated persons, consistent with the standards set out in section 17(b). We believe that this would be true in the context of closed-end funds because the acquired fund's repurchase of its shares would provide little opportunity for the acquiring fund to overreach since all holders would receive the same price.[74]

As a result, we believe that this exemption is necessary and appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.[75] We also believe that the exemption from section 17(a) is necessary in light of the goals of rule 12d1-4, subject to the conditions set forth in the rule. Existing orders have provided exemptive relief from the affiliated transaction provisions in section 17(a) under similar conditions for many years.[76]

Commenters generally supported the proposed exemptions from section 17(a), agreeing with our view that the utility of the proposed rule would be limited if it did not exempt fund of funds arrangements from the affiliated transaction prohibitions in that section.[77] These

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[73] *See* section 22(c) of the Act and 17 CFR 270.22c-1 (rule 22c-1). Primary transactions with an ETF would also be done at a price based on NAV. 2018 FOF Proposing Release, *supra* footnote 6, at n.67.

[74] *See* 2018 FOF Proposing Release, *supra* footnote 6, at n.68.

[75] *See supra* footnote 72.

[76] *See* 2018 FOF Proposing Release, *supra* footnote 6, at n.70.

[77] *See, e.g.,* ICI Comment Letter; Comment Letter of Voya Investment Management LLC (May 2, 2019) ("Voya Comment Letter").

commenters requested, however, that the Commission clarify the availability of the exemption from section 17(a) when an acquired ETF transacts on an in-kind basis with an affiliated acquiring fund. The commenters noted that the 2018 FOF Proposing Release suggests, consistent with fund of funds exemptive orders, that the rule would provide relief for the delivery or deposit of basket assets on an in-kind basis by an affiliated fund (that is, by exchanging certain assets from the ETF's portfolio, rather than in cash), but the proposed rule text referred only to relief to permit the purchase and sale of fund shares between the acquiring fund and acquired fund.

After considering comments, we are adopting a modified exemption from section 17(a) to clarify the rule provides relief from section 17(a) for in-kind transactions when an acquiring fund is purchasing and redeeming shares of an acquired ETF under certain circumstances. As adopted, the rule will provide exemptions from section 17(a) with regard to the deposit and receipt of baskets by an acquiring fund that is an affiliated person of an ETF (or who is an affiliated person of such a person) solely by reason of holding with the power to vote 5% or more of the ETF's shares or holding with the power to vote 5% or more of any investment company that is an affiliated person of the ETF.[78] Consistent with exemptive orders regarding ETF applicants, the exemption will not be available where the ETF is in turn an affiliated person of the acquiring fund, or an affiliated person of such person, for a reason other than such power to vote.[79]

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[78] Rule 12d1-4(a)(3). "Baskets" for purposes of rule 12d1-4 will have the same meaning as in rule 6c-11(a)(1). *See* rule 12d1-4(d).

[79] *See, e.g.,* AQR Trust and AQR Capital Management, LLC, Investment Company Act Release Nos. 33343 (Dec. 21, 2018) [83 FR 67441 (Dec. 28, 2018)] (notice) and 33346 (Jan. 28, 2019) (order) and related application.

We are adopting the rule with this exemption because we agree with commenters that this rule text clarification is appropriate to permit ETFs to engage in in-kind purchase or redemption transactions with certain affiliated acquiring funds on the same basis that they would be permitted to engage in a cash purchase or redemption transactions with such affiliated acquiring fund under the rule.[80] The provision is similar to rule 6c-11(b)(3).[81] Purchases and redemptions of ETF creation units are typically effected in kind, and section 17(a) would prohibit these in-kind purchases and redemptions by a fund affiliated with the ETF. We believe that such an exemption is appropriate because all purchases and redemptions of creation units with such an affiliated fund are at an ETF's next-calculated NAV, and an ETF would value the securities deposited or delivered upon redemption in the same manner, using the same standards, as the ETF values those securities for purposes of calculating the ETF's NAV. We do not believe that these transactions will give rise to the policy concerns that section 17(a) is designed to prevent.[82]

Further, similar to other fund of funds arrangements, without an exemption from section 17(a), the rule would be limited in its utility. In this case, section 17(a) would prohibit the delivery or deposit of basket assets on an in-kind basis by certain affiliated funds (that is, by

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[80] An ETF would be prohibited under section 17(a)(2) from purchasing securities and other property (*i.e.*, securities and other property in the ETF's basket assets) from the affiliated acquiring fund in exchange for ETF shares. An acquiring fund would be prohibited under section 17(a)(1) from selling any securities and other property (*i.e.*, securities and other property in the ETF's basket assets) to an affiliated ETF in exchange for the ETF's shares. The orders we have granted permitting investments in ETFs provide relief from section 17(a) to permit these transactions. *See* Barclays Global Fund Advisors, *et al.*, Investment Company Act Release Nos. 24394 (Apr. 17, 2000) [65 FR 21215 (Apr. 20, 2000)] (notice) and 24451 (May 12, 2000) (order) and related application. In addition, rule 6c-11 under the Investment Company Act and our ETF exemptive orders provide separate affiliated transaction relief for the acquisition or sale of an ETF's basket assets as part of the creation or redemption of ETF creation units, but that relief would not be sufficient to allow an ETF's in-kind transaction with another fund. *See* 17 CFR 270.6c-11; 2019 ETF Adopting Release, *supra* footnote 25.

[81] Rule 6c-11(b)(3). *See supra* footnote 73 and accompanying text. *See also* 2019 ETF Adopting Release, *supra* footnote 25 at section II.B.3.

[82] *See also* 2019 ETF Adopting Release, *supra* footnote 25, at nn.130-134 and accompanying text.

exchanging certain assets from the ETF's portfolio, rather than in cash). As a result, we also believe that the exemption from section 17(a) regarding this limited exception for ETF in-kind baskets is necessary in light of the goals of rule 12d1-4, subject to the conditions set forth in the rule.

Some commenters also suggested the Commission clarify, or provide exemptive relief from, section 17(a) for other affiliated transactions that are within the statutory limits of section 12(d)(1) or fund of funds arrangements that rely on a statutory exemption.[83] A few commenters stated that it would frustrate Congressional intent if the Commission does not extend section 17(a) exemptive relief to these types of fund of funds arrangements.[84]

Section 12 and section 17 address different concerns under the Act. Section 12 addresses concerns regarding "pyramiding," where investors in the acquiring fund could control the assets of the acquired fund and use those assets to enrich themselves at the expense of acquired fund shareholders by virtue of their stake in the acquired fund. Section 17(a) addresses self-dealing and other types of overreaching of a fund by its affiliates. Although an arrangement may not raise pyramiding concerns, it may still give rise to self-dealing concerns. As a result, we do not believe it would frustrate congressional intent, as asserted by commenters, for some fund of funds arrangements that are within the limits of, or exempt from section 12(d)(1) to be subject to the prohibitions of section 17(a).

However, we recognize that certain fund of funds arrangements are nearly impossible to utilize absent relief from section 17(a). In the past, we have considered relief to be implied in

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[83] *See* Voya Comment Letter; ICI Comment Letter; PIMCO Comment Letter; SIFMA AMG Comment Letter. Some commenters focused on suggesting relief from sections 12(d)(1)(A) and 12(d)(1)(F). *See* ICI Comment Letter. Other commenters stated relief should include sections 12(d)(1)(A), (B), (C), (E), (F), and (G). *See* SIFMA AMG Comment Letter; PIMCO Comment Letter.

[84] *See* SIFMA AMG Comment Letter; PIMCO Comment Letter; ICI Comment Letter.

these circumstances. We believe that it is appropriate to imply relief under sections 12(d)(1)(E) and 12(d)(1)(G) because, without this relief, these statutory provisions would be inoperable.[85] Transactions permitted by sections 12(d)(1)(E) and 12(d)(1)(G) are typically affiliated transactions prohibited by section 17(a).[86]

We are not issuing an interpretation that there is an implied exemption from section 17(a) for fund of funds arrangements that involve affiliated persons but do not exceed the limits of sections 12(d)(1)(A), (B), or (C), or that meet the statutory exemption in section (F) of the Act. The section 17(a) exemptions provided in this rule are limited in scope to those necessary for a fund of funds structure to operate under the rule and are consistent with the exemptive relief that we have provided under our exemptive orders. The types of arrangements that are otherwise permissible under section 12(d)(1) could include arrangements where funds are affiliated persons for reasons other than holding 5% or more of the acquired fund's securities. For example, under section 12(d)(1)(A) of the Act, an acquiring fund that acquires only 3% of the total outstanding voting stock of an acquired fund generally would not be an affiliated person by virtue of its

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85 *See, e.g.,* 2018 FOF Proposing Release, *supra* footnote 6, at n.70.

86 *See*, *e.g.*, Section 12(d)(1)(E)(ii) (limiting the exception to situations where the acquiring fund only owns the acquired fund) and section 12(d)(1)(G)(i)(I) (limiting the exception to situations where the two funds are part of the same group of investment companies). For fund of funds arrangements relying on section 12(d)(1)(E), Commission staff has taken the position that application of section 17(a) of the Act to a registered feeder fund's cash redemption from a registered master fund would not be consistent with the basic relationship that section 12(d)(1)(E) is intended to permit. *See* Signature Financial Group, Inc., SEC Staff No-Action Letter (Dec. 28, 1999) ("Signature Financial No-Action Letter"). Section 12(d)(1)(G) of the Act codified certain exemptive orders that the Commission had issued permitting funds to purchase other funds in the same group of funds beyond the limits in section 12(d)(1). The Commission issued those orders generally to funds of funds where the acquiring and acquired funds were related because they shared a common investment adviser or the advisers were affiliated persons within the meaning of section 2(a)(3)(C) of the Act. Those orders provided relief from section 17(a) of the Act. *See, e.g.,* T. Rowe Price Spectrum Fund, Inc., Investment Company Act Release Nos. 21371 (Sept. 22, 1995) [60 FR 50654 (Sep. 22, 1995)] (notice) and 21425 (Oct. 18, 1995) (order) ("T. Rowe Spectrum Order"); Vanguard Star Fund, Investment Company Act Release Nos. 21372 (Sept. 22, 1995) (notice) and 21426 (Oct. 18, 1995) (order); *see also* MassMutual Institutional Funds, SEC Staff No-Action Letter (Oct. 19, 1998).

holdings.[87] Expanding section 17(a) relief to all transactions that are permitted by section 12(d)(1), without the transaction being subject to protections addressing the relevant concerns underlying section 17(a), raises issues that would require a careful consideration of whether additional conditions are necessary to sufficiently address any risks posed by these transactions.

Also, unlike transactions permitted by sections 12(d)(1)(E) and 12(d)(1)(G), transactions under these other provisions are possible without an implied exemption from section 17(a). We have historically considered whether an exemption from section 17(a) is appropriate (and subject to appropriately protective conditions) separately. Thus, while we are not providing the requested interpretation, affiliated arrangements within the statutory limits of section 12(d)(1) or that rely on section 12(d)(1)(F) may continue to apply separately for an exemptive order pursuant to section 17(b).[88] In addition, funds that comply with the conditions in rule 12d1-4 may rely upon the rule's exemption from section 17(a) even if they are not relying upon it for an exemption from section 12(d)(1).

Two commenters requested that we provide an exemption from section 17(d) and rule 17d-1 for affiliated arrangements that rely upon rule 12d1-4, or otherwise comply with section 12(d).[89] We decline to do so. Section 17(d) and rule 17d-1 prohibit first- and second-tier

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87 An acquiring fund's percentage of outstanding shares of the acquired fund owned could increase without further acquisition, such as when there is a decrease in the outstanding securities of the acquired fund, resulting in the acquiring fund exceeding the 5% threshold.

88 For example, some arrangements investing in both affiliated and unaffiliated underlying funds in amounts not exceeding the limits in section 12(d)(1)(F) have received an exemption from section 17(a) for investments in affiliated funds. *See, e.g.*, Hennion & Walsh, Inc., *et al.*, Investment Company Act Release Nos. 26207 (Oct. 14, 2003) [68 FR 59954 (Oct. 20, 2003)] (notice) and 26251 (Nov. 10, 2003) (order).

89 *See* SIFMA AMG Comment Letter; PIMCO Comment Letter. Section 17(d) of the Act makes it unlawful for first- and second-tier affiliates of a fund, the fund's principal underwriters, and affiliated persons of the fund's principal underwriters, acting as principal, to effect any transaction in which the fund or a company controlled by the fund is a joint or a joint and several participant in contravention of such rules and regulations as the Commission may prescribe for the purpose of limiting or preventing participation by such registered or controlled company on a basis different from or less advantageous than that of such other participant. *See* 15 U.S.C. 80a-17(d). Rule 17d-1(a) prohibits first- and second-tier affiliates of a fund, the

affiliates of a fund, the fund's principal underwriters, and affiliated persons of the fund's principal underwriters, acting as principal, from effecting any transaction in which the fund or a company controlled by the fund is a joint or a joint and several participant.[90] They are designed to prevent these persons from managing the fund for their own benefit, rather than for the benefit of the fund's shareholders. Unlike section 17(a) relief, our fund of funds orders do not currently include exemptions from section 17(d) and rule 17d-1.[91] Further, given the fact-specific nature of many rule 17d-1 applications, and the fact that we do not normally provide such relief as part of our fund of funds exemptive orders, we believe it is appropriate to address requests for relief from section 17(d) and rule 17d-1 separately from rule 12d1-4. Fund of funds arrangements within the statutory limits of section 12(d)(1) may apply separately for relief through an application for an order under rule 17d-1 under the Act.

C. Conditions

Consistent with the public interest and the protection of investors, rule 12d1-4 includes conditions designed to prevent the abuses that historically were associated with fund of funds arrangements and that led Congress to enact section 12(d)(1). These conditions are based on the conditions in prior fund of funds exemptive orders[92] and commenters' suggestions. The rule establishes a framework that will subject fund of funds arrangements to a tailored set of

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fund's principal underwriter, and affiliated persons of the fund's principal underwriter, acting as principal, from participating in or effecting any transaction in connection with any joint enterprise or other joint arrangement or profit-sharing plan in which any such fund or company controlled by a fund is a participant "unless an application regarding such joint enterprise, arrangement or profit-sharing plan has been filed with the Commission and has been granted."

90 First-tier affiliates are investment companies and their affiliated persons. Second-tier affiliates are affiliated persons of their affiliated persons.

91 In the past, some fund of funds exemptive orders included relief from section 17(d) and rule 17d-1 for certain service arrangements. *See, e.g.,* T. Rowe Spectrum Order, *supra* footnote 86.

92 Schwab, *supra* footnote 23; Innovator ETFs, *supra* footnote 32.

conditions that address differences in fund structures.[93] The following table sets forth a general overview of the differences among the conditions under our current exemptive relief, proposed rule 12d1-4, and the final rule:

Concern Addressed	Condition Under Existing Exemptive Orders	Proposed Rule Condition	Final Rule Condition
Undue Influence	Voting conditions (including the point at which the voting condition is triggered) differ based on the type of acquired fund. Once an acquiring fund (and any other funds within the advisory group) holds more than 3% of the acquired closed-end fund's outstanding voting securities, the acquiring fund must vote shares of acquired closed-end funds in the manner required by section 12(d)(1)(E) (*i.e.,* either pass-through or mirror voting), while non-fund entities within the advisory group must use mirror voting. For acquired open-end funds or UITs, an acquiring fund (and its advisory group) must vote their shares using mirror voting only if the acquiring fund and its advisory group become holders of more than 25% of the acquired fund's outstanding voting securities due to a decrease in the outstanding securities of the acquired fund.	Voting conditions do not differ based on the type of acquired fund and would require an acquiring fund and its advisory group to use pass-through or mirror voting when they hold more than 3% of the acquired fund's outstanding voting securities.	Voting conditions (including the point at which the voting condition is triggered) differ based on the type of acquired fund. Voting conditions will require an acquiring fund and its advisory group to use mirror voting when they hold more than: (i) 25% of the outstanding voting securities of an open-end fund or UIT due to a decrease in the outstanding securities of the acquired fund; or (ii) 10% of the outstanding voting securities of a closed-end fund. In circumstances where acquiring funds are the only shareholders of an acquired fund, however, pass-through voting may be used.
	Fund boards must make certain findings and adopt procedures to prevent overreaching and undue	An acquiring fund's ability to quickly redeem or tender a large volume of acquired fund shares is	Requires a fund of funds investment agreement between acquiring and acquired funds unless they have the same

[93] For example, the conditions regarding layering of fees vary based on the structure of acquiring fund. *See infra* section II.C.2.b.i.

Concern Addressed	Condition Under Existing Exemptive Orders	Proposed Rule Condition	Final Rule Condition
	influence by the acquiring fund and its affiliates. Requires an agreement between acquiring and acquired funds agreeing to fulfill their responsibilities under the exemptive order (a "participation agreement").	restricted (replacing the requirements for participation agreements and board findings/procedures).	investment adviser that includes any material terms necessary for each adviser to make the appropriate finding under the rule, a termination provision, and a requirement that the acquired fund provide fee and expense information to the acquiring fund.
Complex Structures	Limits the ability of an acquired fund to invest in underlying funds (that is, it limits structures with three or more tiers of funds), subject to certain enumerated exceptions.	Limits the ability of funds relying on certain exemptions to invest in an acquiring fund and limits the ability of an acquired fund to invest in other funds, subject to certain enumerated exceptions. Requires an evaluation of the complexity of the fund of funds structure and aggregate fees. Specific considerations vary by acquiring fund structure.	Adviser(s) of acquiring and acquired funds that are management companies must make certain findings regarding the fund of funds structure. The principal underwriter or depositor of a UIT must analyze the fund of funds structure and determine that the arrangement does not result in duplicative fees. Allows an acquired fund to invest up to an additional 10% of its assets in other funds.
Layering of Fees	Caps sales charges and service fees at limits under current FINRA sales rule (rule 2341) even in circumstances where the rule would not otherwise apply. Requires an acquiring fund's adviser to waive advisory fees in certain circumstances or requires the acquiring fund's board to make certain findings regarding advisory fees.	Requires an evaluation of the complexity of the fund of funds structure and aggregate fees. For management companies, the adviser must determine that it is in the best interest for the acquiring fund to invest.	Generally the same as proposed, but the investment adviser to an acquiring management company must find that the aggregate fees and expenses are not duplicative.

The conditions in rule 12d1-4 as adopted are substantially similar to the conditions that have been included in our exemptive orders since 1999.[94] We discuss each of the conditions below.

1. Control and Voting

a. Control

In order to address concerns that a fund could exert undue influence over another fund, as proposed, rule 12d1-4 will prohibit an acquiring fund and its advisory group from controlling, individually or in the aggregate, an acquired fund, except in the circumstances discussed below.[95] This condition generally comports with the conditions of the exemptive relief the Commission has previously issued.[96]

The 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.[97] The 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.[98] A determination of control is not based solely on ownership of voting securities of a

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94 *See, e.g.,* Schwab, *supra* footnote 23.

95 *See* rule 12d1-4(b)(1)(i); rule 12d1-4(d) (defining "advisory group"). *See also infra* section II.C.1.b.iii. (discussing exceptions to the control condition)].

96 *See, e.g.*, Wells Fargo Funds Trust, *et al.*, Investment Company Act Release Nos. 30201 (Sept. 12, 2012) [77 FR 57597 (Sept. 18, 2012)] (notice) and 30231 (Oct. 10, 2012) (order) and related application (prohibiting an acquiring fund (and its advisory group and sub-advisory group) from controlling an acquired fund).

97 15 U.S.C. 80a-2(a)(9).

98 *Id*. These presumptions continue until the Commission makes a final determination to the contrary by order either on its own motion or on application by an interested person.

company and depends on the facts and circumstances of the particular situation.[99] We have long held that "controlling influence" includes, in addition to voting power, a dominating persuasiveness of one or more persons, the act or process that is effective in checking or directing action or exercising restraint or preventing free action, and the latent existence of power to exert a controlling influence.[100]

We proposed that an acquiring fund and its advisory group could not control (individually or in the aggregate) an acquired fund. Accordingly, an acquiring fund and its advisory group's beneficial ownership of up to 25% of the voting securities of an acquired fund would be presumed not to constitute control over the acquired fund. The acquiring fund, therefore, generally could make a substantial investment in an acquired fund (*i.e.*, up to 25% of the acquired fund's shares). If, however, facts and circumstances gave an acquiring fund and its advisory group the power to exercise a controlling influence over the acquired fund's management or policies (other than as discussed below), the acquiring fund and other funds in its advisory group would not be able to rely on the rule even if the fund and its advisory group owned 25% or less of the acquired fund's voting securities.

Commenters generally supported using the concept of "control" as defined under the Act to guard against potential coercive behavior by an acquiring fund, and agreed that this condition is consistent with the conditions of existing exemptive relief.[101] One commenter stated that the proposed control provision protects acquired funds from undue influence concerns without

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99 "[N]o person may rely on the presumption that less than 25% ownership is not control when, in fact, a control relationship exists under all the facts and circumstances." Exemption of Transactions by Investment Companies with Certain Affiliated Persons, Investment Company Act Release No. 10698 (May 16, 1979) [44 FR 29908 (May 23, 1979)], at n.2.

100 *See* 2018 FOF Proposing Release, *supra* footnote 6, at 32-33, nn.81-82 (discussing facts and circumstances that may constitute controlling influence).

101 *See, e.g.*, ICI Comment Letter; BlackRock Comment Letter.

disrupting investment strategies or creating difficult compliance requirements.[102] We also received more particularized comments relating to control of closed-end funds, as discussed below.

Reflecting these comments, rule 12d1-4 will prohibit an acquiring fund and its advisory group from acquiring, and therefore exercising, control over an acquired fund as proposed.[103] We believe this condition will limit a fund's ability to exert undue influence over another fund.[104] As discussed in more detail below, we addressed commenters' concerns regarding undue influence of acquired closed-end funds by imposing a lower ownership threshold that triggers the rule's voting conditions for such funds, and by requiring mirror voting when an acquiring fund exceeds the threshold.

i. Advisory Group Definition

The rule will require an acquiring fund to aggregate its investment in an acquired fund with the investment of the acquiring fund's advisory group to assess control as proposed.[105] This aggregation requirement is consistent with past exemptive orders and is designed to prevent a

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[102] Invesco Comment Letter.

[103] Like the limits under section 12(d)(1) of the Act, rule 12d1-4's control limitation is an acquisition test. In some circumstances, an acquiring fund's holdings may trigger the Act's control presumption through no action of its own. For example, if the acquiring fund and its advisory group become a holder of more than 25% of the outstanding voting securities of an acquired fund as a result of net redemptions and a decrease in the outstanding voting securities of the acquired fund, the rule does not require the acquiring fund to dispose of acquired fund shares. However, the acquiring fund and other entities within its advisory group may not rely on the rule to acquire additional securities of the acquired fund when the acquiring fund and other entities within its advisory group, in the aggregate, hold more than 25% of the acquired fund's voting securities.

[104] If an acquiring fund has a controlling influence over an acquired fund's management or policies, the acquiring fund would not be able to rely on the proposed rule even if the fund and its advisory group owned 25% or less of the acquired fund's voting securities.

[105] *See* rule 12d1-4(d) defining "advisory group" to mean 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. Under the rule, an acquiring fund would not combine the entities listed in clause (1) with those in clause (2).

fund or adviser from circumventing the control condition by investing in an acquired fund through multiple controlled entities, *e.g.*, other funds in the fund complex.

Commenters recommended that the Commission alter its definition of "advisory group" or revisit the requirement to aggregate affiliated entities for purposes of determining control.[106] For example, several commenters suggested that we adopt a narrower definition of "advisory group," stating that an acquiring fund's investment adviser or depositor may not direct the investments of the affiliates that fall within the proposed definition of "advisory group," and in fact could be unaware of investments by such affiliates.[107] One of these commenters stated that this definition of advisory group could be particularly problematic for large financial services organizations that have many affiliates under common control, but that operate independently.[108] Some commenters recommended that the aggregation requirement exclude affiliates that are not subject to actual control by the investment adviser or exclude certain control affiliates where there are information barriers or other limits.[109] One commenter stated that section 12(d)(1)(A) of the Act does not require an investment adviser to aggregate holdings across its private funds for purposes of determining control and suggested that rule 12d1-4 follow a similar approach.[110]

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106 *See, e.g.*, ICI Comment Letter; BlackRock Comment Letter. Another commenter generally supported a requirement that funds advised by the same adviser cannot in the aggregate hold in excess of 3% of the outstanding voting securities of a given acquired fund. Comment Letter of General American Investors Company, Inc. (May 2, 2019).

107 ICI Comment Letter; ABA Comment Letter; Voya Comment Letter.

108 ICI Comment Letter (noting that many affiliates may have firewall restrictions that prevent the affiliates from coordinating their investments).

109 *See, e.g.*, ABA Comment Letter; SIFMA AMG Comment Letter; Dechert Comment Letter. One commenter further suggested that the Commission clarify that a feeder fund that invests in an acquired fund in reliance on Section 12(d)(1)(E) should not be included in the advisory group's ownership calculation, noting that a feeder fund is already required to use pass-through or mirror voting pursuant to 12(d)(1)(E)(iii)(aa). Comment Letter of Capital Research and Management Company (May 2, 2019) ("Capital Group Comment Letter").

110 MFA Comment Letter.

This commenter suggested that the Commission instead prevent an acquiring fund from seeking to exert control over an acquired fund by including a general provision in the rule prohibiting an entity from doing anything indirectly which, if done directly, would violate the rule.

On the other hand, some commenters suggested that the Commission should adopt a broader definition of advisory group than proposed.[111] Specifically, these commenters recommended that the Commission expand the aggregation requirement to include all accounts managed by the acquiring fund's adviser, subadviser or their respective affiliates.

Upon considering the comments received, we continue to believe requiring an acquiring fund to aggregate its holdings with its advisory group will help prevent a fund or adviser from circumventing the control condition. Because the control condition effectively allows an acquiring fund and its advisory group to obtain a significant ownership stake in an acquired fund by investing through multiple related entities, we believe it is appropriate to subject all of the affiliates in an advisory group to this condition. Our exemptive orders include a similar condition, and funds relying on those orders likely already have established policies and procedures to monitor compliance with the aggregation requirement embedded in the definition of the term "advisory group."[112]

We acknowledge that the definition of "advisory group" may capture many affiliates of an acquiring fund and its investment adviser in a complex financial services firm, and will result in monitoring and compliance burdens that are greater than if the definition only looked to the holdings of an acquiring fund and its adviser. To the extent that a particular advisory group has

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[111] Advent Comment Letter; Comment Letter of Skadden, Arps, Slate, Meagher & Flom LLP (May 2, 2019) ("Skadden Comment Letter").

[112] *See, e.g.,* Symmetry Panoramic Trust and Symmetry Partners, LLC, Investment Company Act Release Nos. 33317 (Dec. 6, 2018) [83 FR 63918 (Dec. 12, 2018)] (notice) and 33364 (Feb. 1, 2019) (order) and related application.

not already established policies and procedures pursuant to an exemptive order, we also acknowledge that the advisory group may need to restructure information barriers to permit entities within the advisory group to share the necessary information to comply with the rule. However, other provisions of the Act and our rules also extend to affiliated persons of an investment adviser.[113] These provisions apply to affiliated persons, regardless of the complexity that may arise because of the way in which a financial services firm has determined to structure itself. Funds (and their advisers) have experience developing compliance policies and procedures in those circumstances.[114] We believe that requiring the entities that fall within this definition to aggregate their holdings in an acquired fund for purposes of the control condition will more effectively address the risk of undue influence over an acquired fund.

The breadth of entities that are included within an advisory group will reduce the risk that an acquiring fund and its advisory group will exert undue influence over an acquired fund by accumulating a controlling ownership position across the advisory group's accounts. We believe that the condition's definition of advisory group strikes an appropriate balance between the flexibility for efficient market activity and protection of acquired funds and their shareholders.

Additionally, we continue to believe that the advisory group definition should not encompass funds managed by unaffiliated sub-advisers. Absent common control, there is little risk that an advisory group and sub-advisory group would coordinate to exert undue influence on

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113 *See, e.g.*, section 17(a) of the Act (prohibiting first- and second-tier affiliates of a fund from borrowing money or other property, or selling or buying securities or other property to or from the fund, or any company that the fund controls). *See also supra* footnote 68 and accompanying text.

114 *See* 17 CFR 270.38a-1 (rule 38a-1 under the Act) (requiring registered investment companies to adopt, implement and periodically review written policies and procedures reasonably designed to prevent violations of the federal securities laws). *See also* Compliance Rule Adopting Release, *supra* footnote 59 (noting that funds or their advisers should have policies and procedures in place to identify affiliated persons and to prevent unlawful transactions with them).

an acquired fund.[115] Consistent with past exemptive orders, therefore, rule 12d1-4 will not require an acquiring fund to aggregate the ownership of an acquiring fund advisory group with an acquiring fund sub-advisory group. Instead, each of these groups will consider its ownership percentage separately and will be subject to the voting provisions as discussed below.[116]

ii. Closed-End Funds

Rule 12d1-4 will include voting requirements specific to acquired closed-end funds in response to concerns raised by commenters with respect to undue influence over closed-end funds.[117] The proposed rule included voting requirements, as described in section II.C.1.b below, and would have required that an acquiring fund and its advisory group not control (individually or in the aggregate) any acquired fund, whether open-end or closed-end.[118] As discussed above, the rule 12d1-4 control prohibition also applies if facts and circumstances exist that give an acquiring fund and its advisory group the power to exercise a controlling influence over an acquired closed-end fund's management or policies, even if the acquiring fund and its advisory group owned 25% or less of the acquired closed-end fund's voting securities.[119]

In the 2018 FOF Proposing Release, we requested comment on whether the rule's control and voting requirements should vary depending on the type of acquired fund, including whether there should be a lower or higher threshold for closed-end funds, and whether the threshold

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115 However, if the sub-adviser or any person controlling, controlled by, or under common control with such investment sub-adviser acts as an acquired fund's investment adviser or depositor, then the sub-advisory group and advisory group will be required to aggregate their ownership for purposes of determining control pursuant to rule 12d1-4(b)(1)(i).

116 *See* rule 12d1-4(b)(1)(ii).

117 These voting conditions will also apply to voting of shares of acquired BDCs. *See* rule 12d1-4(b)(1)(ii).

118 Proposed rule 12d1-4(b)(1).

119 *See* 2018 FOF Proposing Release, *supra* footnote 6, at 32-33.

should differ for listed and unlisted closed-end funds.[120] As adopted, the rule does not impose a lower investment limit on investments in a closed-end fund by an acquiring fund and its advisory group; however, the rule will impose a mirror-voting requirement at a lower ownership threshold than the voting requirements applicable to open-end funds and UITs. Specifically, the rule will require mirror voting if an acquiring fund and its advisory group hold more than 10% of the voting securities of a closed-end fund. This voting requirement is designed to protect an acquired closed-end fund from undue influence through the shareholder vote mechanism. In addition, the rule will require an acquiring fund to enter into a fund of funds investment agreement with an acquired fund prior to exceeding the investment limits set forth in section 12(d)(1). Together, these provisions are designed to protect acquired closed-end funds from undue influence by acquiring funds and their advisory groups.

Several commenters recommended alternatives to the proposed control condition for fund of funds arrangements with acquired closed-end funds. For example, commenters recommended that, instead of relying on the concept of "control" for acquired closed-end funds, rule 12d1-4 should limit the aggregate ownership by an acquiring fund and its advisory group to 10% of an acquired closed-end fund's voting securities in order to protect these funds from undue influence.[121] One commenter stated that an acquiring fund that holds approximately 15% of an acquired closed-end fund could dictate certain actions of the acquired closed-end fund.[122] The

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[120] *Id.* at 45. We requested comment on whether the proposed control and voting conditions sufficiently protect acquired funds, and whether there may be other conditions that would address the potential for undue influence by an acquiring fund and its controlling persons, including a lower limit on investments by an acquiring fund and its advisory group in an acquired fund. *Id.* at 43.

[121] Advent Comment Letter; Comment Letter of TPG Specialty Lending, Inc. (May 2, 2019) ("TPG Comment Letter.").

[122] Advent Comment Letter (stating that holdings below the 25% level result in the type of undue influence the Commission is seeking to prevent, such as a large holder being able to dictate various events including the initiation of a proxy contest). *See also* PIMCO Comment Letter (recommending that, if private funds and

commenter also recommended expanding the definition of advisory group and requiring an acquiring fund (and the expanded advisory group) to reduce its holdings in an acquired fund to less than 25% within a defined period of time in order to discourage activist investors from increasing their holdings in target funds just prior to effectiveness of the rule.[123]

Two commenters encouraged the Commission to allow acquired funds and their boards, at their option, to set their own limit for an acquiring fund's investments.[124] These commenters suggested that an agreement between an acquiring and acquired fund (similar to a participation agreement under current fund of funds exemptive relief) could allow the acquired fund and its board to evaluate the effects of the acquiring fund's investment, including any risks of undue influence, and set an appropriate limit.[125] Similarly, commenters suggested that the rule should provide acquired funds with the ability to grant consent to potential investments by acquiring funds, effectively permitting acquired funds to screen their investors and refuse investments by acquiring funds based on undue influence concerns.[126]

Other commenters suggested the Commission adopt a passive investor certification and reporting regime similar to that under Section 13 of the Securities Exchange Act of 1934 and

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foreign funds are permitted to rely on the rule, such funds must act within the limits of section 12(d)(1)(C) as if they were registered funds); Skadden Comment Letter; ICI Comment Letter. Section 12(d)(1)(C) prohibits funds (together with companies or funds they control and funds that have the same adviser) from acquiring more than 10% of the outstanding voting stock of a closed-end fund. 15 U.S.C. 80a-12(d)(1)(C).

123 Advent Comment Letter.

124 Dimensional Comment Letter (noting that a higher discretionary investment limit might be beneficial for a newly formed or smaller fund that seeks large investments by acquiring funds in order to achieve economies of scale); Advent Comment Letter (explaining that an acquired fund might use a participation agreement to permit an acquiring fund to purchase more than 10% of its voting securities, and the participation agreement can require passive investment).

125 Dimensional Comment Letter, Advent Comment Letter.

126 ABA Comment Letter; AIC Comment Letter; Dimensional Comment Letter (explaining that the participation agreement requirement of existing exemptive relief has been helpful for a potential acquired fund to refuse large investments by an acquiring fund that may present a risk of undue influence, and recommending the preservation of such a control).

Schedules 13D and 13G to protect acquired closed-end funds against undue influence.[127] Under such a regime, an acquiring fund would certify to the Commission, or would only be able to operate in accordance with rule 12d1-4, if it holds the acquired fund's securities in the ordinary course of business and not for the purpose of or with the effect of changing or influencing the management or policies of the acquired fund. Commenters representing closed-end funds or their investors also recommended that, if rule 12d1-4 were to permit private funds to acquire closed-end funds, it should incorporate additional protections specific to closed-end funds.[128]

Rule 12d1-4, as adopted, will prohibit an acquiring fund and its advisory group from exercising control over an acquired closed-end fund and will impose a mirror-voting requirement if an acquiring fund and its advisory group hold more than 10% of the voting securities of a closed-end fund.[129] We believe these conditions will more effectively address undue influence concerns regarding acquired closed-end funds than a reporting or certification requirement on acquiring funds, and they will avoid potential duplicative reporting requirements on certain acquiring funds.[130]

As an additional protective condition, discussed below in section II.C.2, the rule will require an acquiring fund and an acquired closed-end fund that do not share an investment adviser to enter into a fund of funds investment agreement prior to the acquiring fund exceeding

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127 Skadden Comment Letter; BlackRock Comment Letter.

128 *See, e.g.*, Comment Letter of Nuveen, LLC (May 2, 2019) ("Nuveen Comment Letter"); SIFMA AMG Comment Letter; PIMCO Comment Letter; Skadden Comment Letter; Voya Comment Letter; Guggenheim Comment Letter; Advent Comment Letter.

129 *See* rule 12d1-4(b)(1). This voting requirement applies at a 10% ownership threshold, while the Act 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.

130 *See, e.g.,* Part C of Form N-PORT (requiring monthly disclosure of certain registered management investment companies' portfolio holdings, including disclosure of investments in other investment companies).

the investment limits of section 12(d)(1)(A). This agreement will enable an acquired closed-end fund to screen potential acquiring fund investors and set conditions on investments in the acquired fund, if desired. The agreement also will allow an acquired closed-end fund to terminate the agreement with an acquiring fund without penalty, which would then prohibit the acquiring fund from making additional purchases of the acquired fund beyond the section 12(d)(1)(A) limits.

Rule 12d1-4 also includes voting requirements specific to closed-end funds that preserve voting discretion for investment advisers below a specified threshold of ownership, while seeking to avoid amplifying the voting power of any particular investor.[131] These voting requirements are described in the section below. Finally, because private funds will not be permitted to rely on the rule as acquiring funds, we are not adopting any specific conditions associated with private fund investments in closed-end funds under rule 12d1-4.

In addition to comments on closed-end fund issues under the rule, several commenters raised general concerns about private fund investments in closed-end funds that are outside the scope of rule 12d1-4.[132] These commenters stated that there have been instances in which an investment adviser to several private funds (each with less than 3% of the outstanding voting shares of a closed-end fund) acquired a significant aggregate interest in an acquired closed-end fund and sought to unduly influence the fund to the detriment of long-term shareholders through

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131 *See infra* section II.C.1.b.

132 *See, e.g.*, Comment Letter of Center for Capital Markets Competitiveness, U.S. Chamber of Commerce (May 2, 2019) ("Chamber of Commerce Comment Letter") (recommending that the Commission review existing rules to address "regulatory loopholes" related to fund of funds structures and ownership thresholds); Comment Letter of Anthony S. Colavita (Apr. 30, 2019); Comment Letter of Anthonie van Ekris (Apr. 30, 2019); Comment Letter of Kinchen C. Bizzel (May 2, 2019); Comment Letter of Salvatore Subblells (May 2, 2019); Comment Letter of Peter Baldino (May 2, 2019); Comment Letter of Clarence A. Davis (May 2, 2019). *See* 2018 FOF Proposing Release, *supra* footnote 6, at n. 95 and accompanying text.

proxy contests or other means.[133] The commenters recommended various ways to address these private fund investments in closed-end funds under section 12(d)(1). For example, these commenters recommended that the Commission: (i) recommend legislation to deem any private fund an "investment company" for purposes of section 12(d)(1)(C) of the Act;[134] (ii) extend the 3% limit of section 12(d)(1)(A)(i) to any separate accounts for which an advisory group has sole or shared voting or disposition authority;[135] (iii) deem ownership of more than 3% of a registered fund by a private fund advisory group to be a violation of section 12(d)(1)(A)(i) pursuant to section 48(a) of the Act;[136] or (iv) treat affiliated private funds that "are not materially different in investment operations or investment policies" as a single fund for purposes of section 12(d)(l).[137]

On the other hand, some commenters opposed restrictions on private fund investments in closed-end funds under section 12(d)(1).[138] These commenters stated that private funds invest in closed-end funds in accordance with the relevant provisions of the Act. In addition, one commenter stated that Congress did not impose more restrictive limits on the ability of private

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133 *See, e.g.*, Advent Comment Letter; Skadden Comment Letter; ICI Comment Letter; Comment Letter of Gabelli Funds, LLC (Apr. 30, 2019) ("Gabelli Comment Letter"); Nuveen Comment Letter. One commenter requested that the Commission analyze private funds' actual capacity for exercising voting control, as well as indirect forms of influence, over an acquired closed-end fund. Great American Comment Letter.

134 ICI Comment Letter; Comment Letter of Calamos Investments LLC (May 2, 2019) ("Calamos Comment Letter"); Nuveen Comment Letter; Dechert Comment Letter; Voya Comment Letter; Guggenheim Comment Letter. *See also* Gabelli Comment Letter (recommending that the Commission seek legislative changes to create a private right of action to enforce rules relating to activist investment in closed-end funds).

135 Gabelli Comment Letter.

136 Advent Trustees Comment Letter; Gabelli Comment Letter; Advent Comment Letter; Skadden Comment Letter.

137 Skadden Comment Letter.

138 Comment Letter of Saba Capital Management, L.P. (May 1, 2019) ("Saba Comment Letter"); Comment Letter of City of London Investment Management Co Ltd (May 2, 2019) ("City of London Comment Letter"); Comment Letter of Bulldog Investors, LLC (May 6, 2019) ("Bulldog Comment Letter"); TPG Comment Letter.

funds to acquire equity stakes in regulated funds when it amended the Act to subject private funds to the restrictions of sections 12(d)(1)(A)(i) and 12(d)(1)(B)(i).[139]

After considering comments, we believe 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 this rulemaking.[140]

b. Voting Provisions

The final rule will require an acquiring fund and its advisory group to vote their shares of an acquired fund: (i) using mirror voting if the acquiring fund and its advisory group (in the aggregate) hold more than 25% of the outstanding voting securities of an acquired open-end fund or UIT due to a decrease in the outstanding securities of the acquired fund;[141] and (ii) using mirror voting if the acquiring fund and its advisory group (in the aggregate) hold more than 10% of the outstanding voting securities of an acquired closed-end fund or BDC.[142] Similar to our exemptive orders, the final rule's voting conditions will differ based on the type of acquired fund.

Proposed rule 12d1-4 would have required an acquiring fund and its advisory group to vote their securities in the manner prescribed by section 12(d)(1)(E)(iii)(aa) of the Act if the acquiring fund and its advisory group (in the aggregate) hold more than 3% of the outstanding

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139 Saba Comment Letter, citing NSMIA at sections 209(a)(1) and 209(a)(4)(D) (codified at Sections 3(c)(1) and Section 3(c)(7) of the Investment Company Act).

140 *See supra* footnotes 133-137 and accompanying text.

141 In circumstances where acquiring funds are the only shareholders of an acquired fund, however, pass-through voting may be used.

142 Mirror voting requires the fund to vote the shares held by it (and, under rule 12d1-4, an acquiring fund's advisory group) 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.

voting securities of an acquired fund.[143] The proposed rule would have applied a uniform condition across all types of acquired funds to simplify and streamline the requirement. Commenters generally supported the proposed voting conditions, stating that they protect acquired funds without disrupting current investment strategies or creating new or difficult compliance requirements.[144] As discussed in more detail below, however, some commenters suggested modifications to the ownership threshold that would trigger the voting condition or the required manner of voting, based on the type of acquired fund.[145]

We believe that the voting conditions of the final rule, which we modified to respond to the concerns expressed in these comments, will help to facilitate compliance monitoring and are better tailored to address the potential for undue influence through voting power based on the types of acquired fund.

i. Ownership Threshold

The final rule will impose voting conditions if an acquiring fund and its advisory group hold more than 25% of the voting securities of an acquired open-end fund or UIT due to a decrease in the outstanding voting securities of the acquired fund.[146] For acquired BDCs and other closed-end funds, the rule will impose voting conditions at a 10% ownership threshold. The proposed rule included a 3% ownership threshold that would trigger the rule's voting

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143 Proposed rule 12d1-4(b)(1)(ii). Section 12(d)(1)(E)(iii)(aa) of the Act requires an acquiring fund to either: (i) seek voting instructions from its security holders and vote such proxies in accordance with their instructions ("pass-through voting"); or (ii) use mirror voting.

144 Invesco Comment Letter; CFA Comment Letter (specifically supporting the application of the voting condition to an acquiring fund and its advisory group).

145 *See* Invesco Comment Letter; CFA Comment Letter, WisdomTree Comment Letter; IPA Comment Letter; Advent Comment Letter; Skadden Comment Letter; FS Comment Letter; ABA Comment Letter.

146 Rule 12d1-4(b)(1)(ii).

conditions, and we requested comment on whether that ownership threshold should be higher or lower, and whether it should differ depending on the type of acquired fund.[147]

A number of commenters recommended raising the 3% ownership threshold that would trigger the voting conditions in the proposed rule, stating that a 3% threshold would substantially increase the administrative burden on an advisory group to monitor and vote shares.[148] For example, some commenters recommended the rule raise the ownership threshold from the proposed 3% to 10% to better reflect an ownership level at which an acquiring fund would be able to influence a shareholder vote.[149] One commenter argued that the rule should allow acquiring funds to hold larger positions in closed-end funds without forfeiting the right to exercise their independent judgment regarding shareholder proposals to ameliorate certain unintended consequences associated with a lower threshold.[150]

Several commenters recommended that the rule adopt the voting triggers set forth in exemptive orders.[151] These commenters stated that current exemptive orders only impose voting requirements when a fund and its advisory group hold, in aggregate, more than 25% of the outstanding voting securities of an acquired open-end fund or UIT. They also noted that open-

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147 2018 FOF Proposing Release, *supra* footnote 6, at 45.

148 Comment Letter of Charles Schwab Investment Management (May 2, 2019) ("Schwab Comment Letter"); Voya Comment Letter. *But see* SIFMA AMG Comment Letter ("[T]he voting and control provisions do not create significant operational challenges for funds and … they may prove to be an unobtrusive means to address some of Congress's concerns relating to voting control…").

149 MFA Comment Letter; Nuveen Comment Letter. *But see* Advent Comment Letter (stating that an acquiring fund that holds approximately 15% of an acquired fund can dictate certain actions of the acquired fund).

150 SIFMA AMG Comment Letter ("AMG has observed that activist firms are utilizing multiple private funds to acquire significant positions in CEFs, but such private funds would not be subject to the Proposed Rule. In contrast, registered funds investing in CEFs would be subject to this voting condition. Therefore, such registered funds would likely mirror vote shares held in any CEF subject to the voting condition. This would have the effect of increasing the voting power of activist firms… We believe the Commission could mitigate this concern by increasing the percentage beyond which an acquiring fund and its advisory group are required to mirror or pass-through vote.").

151 Schwab Comment Letter; SIFMA AMG Comment Letter; ICI Comment Letter; ABA Comment Letter.

end funds and UITs may not be particularly susceptible to influence by shareholder votes because they do not hold routine shareholder meetings. Accordingly, these commenters stated that there was little practical or policy justification to impose voting requirements at a 3% ownership threshold on shares of acquired open-end funds and UITs.[152] In contrast, these commenters stated that closed-end funds may be required to hold annual shareholder meetings and can be the target of proxy contests, which may make such funds more susceptible to influence by shareholder vote. Commenters addressing the closed-end fund market segment generally recommended that the Commission adopt a lower voting threshold for acquiring funds' holdings in closed-end funds than the threshold for acquiring funds' holdings in open-end funds and UITs.[153]

After considering the comments received, we believe that it is appropriate that the final rule include voting requirements for investments in open-end funds and UITs that are consistent with the voting requirements imposed by prior exemptive orders in this area. We are persuaded that the 25% ownership threshold is appropriate for open-end funds and UITs given that these funds hold shareholder meetings infrequently, and because commenters did not raise concerns about undue influence of these funds through shareholder voting. The rule's voting conditions therefore will apply to the same scope of entities in an acquiring fund's advisory group as the voting conditions in our existing fund of funds exemptive orders. A 25% ownership threshold will also minimize the administrative burden associated with the voting requirement for these funds.[154] Accordingly, the final rule will require mirror voting if an acquiring fund and its

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152 ICI Comment Letter; Voya Comment Letter; Schwab Comment Letter.

153 *See, e.g.*, Nuveen Comment Letter, SIFMA AMG Comment Letter.

154 Since our existing fund of funds exemptive orders currently impose voting requirements on an advisory group's holdings in an acquired fund, we understand from commenters that some advisory groups may

advisory group hold more than 25% of the voting securities of an open-end fund or UIT. We expect an acquiring fund would only exceed 25% of the securities of an open-end fund or UIT due to a decrease in the outstanding voting securities of the acquired fund because the rule prohibits an acquiring fund from controlling an acquired fund and because of the rebuttable presumption regarding control under the Act.[155]

However, the rule will impose a 10% ownership threshold on acquired closed-end funds. We believe a 10% ownership threshold (an increase from the proposed 3% threshold) will permit an acquiring fund and its advisory group to gain substantial exposure to such funds with full voting discretion, but will reduce undue influence concerns associated with shareholder votes, which are greater for acquired closed-end funds than for other types of acquired funds given the more frequent shareholder meetings.[156] We are 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.

ii. Mirror Voting

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already have systems in place to monitor holdings at the "advisory group level" and engage in mirror voting when appropriate or required. *See, e.g.,* Invesco Comment Letter; SIFMA AMG Comment Letter. To the extent that an advisory group utilizes information barriers and determines to rely on this rule, the advisory group may need to update its policies and procedures to allow entities across the advisory group to monitor compliance with the aggregate ownership thresholds set forth in rule 12d1-4. *See, e.g.,* Dechert Comment Letter.

155 The Act 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. The presumption of control continues until the Commission makes a final determination to the contrary by order either on its own motion or on application by an interested person. *See* 15 U.S.C. 80a-2(a)(9).

156 *See, e.g.,* Nuveen Comment Letter (stating that a 10% threshold is a reasonable ownership threshold to limit undue influence concerns while allowing acquiring funds to hold larger positions in closed-end funds without forfeiting the right to exercise their independent judgment regarding shareholder proposals); MFA Comment Letter (stating that a 10% ownership threshold would appropriately balance the need to prevent influence of shareholder votes with allowing acquiring funds that do not have the ability to influence acquired funds to participate in shareholder votes).

The final rule will require mirror voting if an acquiring fund and its advisory group hold more than (i) 25% of the outstanding voting securities of an open-end fund or UIT due to a decrease in the outstanding voting securities of the acquired fund or (ii) 10% of the outstanding voting securities of an acquired BDC or other closed-end fund. As described above, the proposed rule would have required acquiring funds to use either pass-through or mirror voting if the acquiring fund and its advisory group exceeded a set ownership threshold, regardless of the type of acquired fund. In the 2018 FOF Proposing Release, we requested comment on whether we should adopt the voting requirements of the proposed rule, or whether the final rule should codify the voting provisions set forth in existing exemptive orders.[157]

Several commenters suggested modifications to the proposed voting requirement. For example, one commenter generally opposed pass-through voting for closed-end fund voting securities because an activist acquiring fund and its advisory group would likely vote according to the recommendations of its activist investment manager.[158] This commenter suggested that the rule permit pass-through voting of investments in an acquired closed-end fund only if required by the terms of an adviser's investment advisory contract. Another commenter recommended that the rule require an acquiring fund to mirror vote its shares of an acquired open-end fund if it controls the acquired fund.[159] The commenter explained that, at a beneficial ownership of more than 25% of the voting securities of an acquired open-end fund, there is a greater risk that an acquiring fund can exert undue influence on the acquired fund and thus the burden of mirror voting acquired fund shares is a reasonable trade-off.

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157 2018 FOF Proposing Release, *supra* footnote 6 at 45-46.

158 Advent Comment Letter.

159 Voya Comment Letter.

Some commenters stated that the rule's proposed voting requirements could conflict with an acquiring fund adviser's fiduciary duty to vote underlying fund shares in the best interest of the acquiring fund.[160] These commenters stated that large advisory firms may serve many clients with different investment strategies and shareholder voting interests, and a voting requirement that applies across an advisory group could cause an affiliate of an acquiring fund to be in violation of its fiduciary duties under Sections 404(a)(1)(A) and (B) of the Employee Retirement Income Security Act of 1974 if forced to adhere to the rule's voting requirements. Further, commenters stated that a mirror-voting requirement may require an adviser to vote fund holdings in a manner that is contrary to its proxy voting policies.[161]

Some commenters expressed concern regarding the effect of the required voting procedures for acquired closed-end funds. These commenters stated that requiring acquiring funds to use mirror voting if they hold more than 3% of an acquired closed-end fund may increase the relative voting power of private funds or separate account structures that would not rely on rule 12d1-4, and therefore would not be subject to the voting requirements of the rule.[162] These commenters noted that mirror voting by an acquiring fund and its advisory group at a low ownership threshold could effectively amplify the voting position of these types of investors.

After considering comments, we believe it is appropriate to require acquiring funds and their advisory group to use mirror voting. However, in circumstances where rule 12d1-4 or

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160 ICI Comment Letter (stating that there may be shareholder proposals, such as merger approvals or changes to fundamental investment strategy, for which an adviser believes that neither mirror voting nor pass-through voting is in the acquiring fund's or shareholders' best interest); Voya Comment Letter. The voting conditions are similar to those included in our existing exemptive orders.

161 Schwab Comment Letter.

162 SIFMA AMG Comment Letter (noting that activist investors have historically accumulated ownership of closed-end funds through separate investments by private funds and separately managed accounts); Nuveen Comment Letter.

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 acquiring fund's shares must be "passed-through" to the acquiring funds' shareholders for voting purposes. We believe requiring an acquiring fund and its advisory group to use mirror voting in most cases, with an ownership threshold set at 25% for open-end funds and UITs and at 10% for closed-end funds, will help address the commenters' concerns regarding undue influence over acquired funds through shareholder voting.[163] We further believe that requiring an acquiring fund and its advisory group to use mirror voting in most cases, without generally providing the option for pass-through voting, will simplify operational and compliance burdens for acquiring funds and their advisory groups. For example, this approach will facilitate compliance monitoring for fund groups that have multiple types of acquiring funds. As under our existing exemptive orders, we believe an adviser would need to consider these voting requirements as a component of its fiduciary duty when determining whether and how much an acquiring fund should invest in an acquired fund under the rule.

iii. Exceptions to the Control and Voting Conditions

We are adopting, as proposed, exceptions to the control and voting conditions when: (i) an acquiring fund is within the same group of investment companies as an acquired fund; or

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[163] One commenter recommended that the rule prescribe a mirror voting procedure whereby the acquiring fund must provide legal proxy to the proxy agent for the shareholder vote and request that the acquiring fund's shares be voted in the same proportion as the vote of all other shareholders. Bulldog Comment Letter. We do not believe it is necessary to include such a prescription in this rule because we understand that proxy agents are able to tabulate and process shareholder votes that are subject to a mirror-voting requirement and such agents would not require a legal proxy to be set forth in the rule text.

(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.[164] The exceptions are designed to include arrangements that are permissible under section 12(d)(1)(G) and our exemptive orders within the regulatory framework of rule 12d1-4.[165] We define 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.[166]

Commenters supported these exceptions.[167] Commenters agreed with the Commission that, in circumstances where an affiliated investment manager manages the acquiring fund, it is unlikely that the investors in the acquiring fund would exert undue influence and use their vote to pursue initiatives that are inconsistent with the long-term interests of investors in the acquired fund.[168] Based on our experience overseeing fund of funds arrangements, we believe these exceptions from the control and voting conditions are appropriately tailored to except only those fund of funds arrangements that do not raise the concerns of undue influence that underlie section 12(d)(1).

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164 Rule 12d1-4(b)(1)(iii). The exception to the control and voting conditions for sub-advisory arrangements will cover arrangements that may not qualify for the exclusion otherwise available to funds within the same group of investment companies if the acquiring fund and acquired fund do not hold themselves out as related funds for purposes of investment and investor services. *See* 2018 FOF Proposing Release, *supra* footnote 6, at n.106 and accompanying text.

165 *See* 2018 FOF Proposing Release, *supra* footnote 6, at section II.C.1.b.

166 Rule 12d1-4(d).

167 *See, e.g.,* Invesco Comment Letter; ABA Comment Letter.

168 Commenters suggested excluding funds within the same group of investment companies from other conditions of the proposed rule, including the proposed redemption limit. While we are not adopting the proposed redemption limit, we have tailored the rule's conditions to account for the different undue influence concerns of funds within the same group of investment companies as compared to funds that are not part of the same group of investment companies.

The definition of "group of investment companies" is similar to the definition used in many of our exemptive orders permitting investments in listed closed-end funds and listed BDCs. It is intended to clarify that BDCs and other closed-end funds are within the scope of this exception. The determination of whether advisers are control affiliates, however, depends on the relevant facts and circumstances.[169]

We believe that whether a group of funds sharing a common adviser or having advisers that are all control affiliates could satisfy the "holding out" prong of the definition would depend on the totality of communications with investors by or on behalf of the funds. For example, the acquiring fund's prospectus could identify the acquired funds in which the acquiring fund expects to invest, and disclose the control relationship among the advisers to the acquiring and acquired funds. In our view, it is not necessary for acquired funds to include comparable disclosure in their prospectuses or for acquired funds and acquiring funds to market themselves as related companies for all purposes and to all potential investors.[170] Rather, the requirement in this definition that the funds must hold themselves out to "investors" as related companies for purposes of investment and investor services refers only to potential investors in the acquiring fund because the relevant inquiry is how these funds are holding themselves out to their potential investors. Disclosure in the acquiring fund's prospectus of the identity of the acquired funds in

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[169] We believe, for example, that funds that are advised by the same investment adviser, or by advisers that are control affiliates of each other, would be "related" companies for purposes of the rule. The definition of "affiliated person" includes any person directly or indirectly controlling, controlled by, or under common control with, such other person. *See* section 2(a)(3)(C) of the Act. *See also* Investment Company Mergers, Investment Company Act Release No. 25259 (Nov. 8, 2001) [66 FR 57602 (Nov. 15, 2001)] (proposing rule amendments to permit mergers and other business combinations between certain affiliated investment companies), at n.11.

[170] If the acquired funds' marketing materials and/or prospectuses include any statements that are inconsistent with the representations made in the prospectuses for the acquiring funds regarding how the acquired fund and acquiring funds are related companies because of the affiliation of their investment advisers, such statements could call into question whether the funds are holding themselves out as related companies and potentially render the control exception unavailable to the fund of funds arrangement.

which the acquiring fund expects to invest, and of the control relationship among the advisers to the acquired and acquiring funds, therefore, is one way to satisfy the "holding out" requirement of the definition. As we stated in the 2018 FOF Proposing Release, we believe that it would be false or misleading for a group of investment companies to hold themselves out as related companies as that term is used in rule 12d1-4 unless they are related investment companies.

As proposed, the rule will subject fund of funds arrangements within these exclusions to a more limited set of conditions than other fund of funds arrangements. 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.[171] In addition, where the arrangement involves funds that are advised by advisers that are control affiliates, we do not believe that the acquiring fund adviser generally would seek to benefit the acquiring fund at the expense of the acquired fund. Nor do we believe that the acquiring fund would seek to influence the acquired fund through its ownership interest in the acquired fund.[172] We believe that the rule's other conditions, such as the fund of funds investment agreement and adviser findings described below, would mitigate the risks of undue influence when the arrangement involves funds that have advisers that are control affiliates.

2. Redemption Limits, Fund Findings, and Fund of Funds Investment Agreements

In lieu of the proposed limitation on redemptions by an acquiring fund, we are adopting a requirement, expanded from the proposal, for an investment adviser to a management company operating in accordance with the rule to evaluate and make certain findings regarding the

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171 *See* 2018 FOF Proposing Release, *supra* footnote 6, at 41 and associated footnotes.

172 *Id.*

arrangement.[173] The rule will also require tailored findings regarding acquiring UITs and a certification regarding separate accounts funding variable insurance contracts (these findings and certifications, collectively with the management company evaluations and findings, "Fund Findings"). In addition, unless they have the same adviser, the acquiring fund and acquired fund will be required to enter into a fund of funds investment agreement effective for the duration of the funds' reliance on the rule, which must include certain specific terms. These provisions are, as discussed below, designed to address concerns over the exercise of undue influence through excessive redemptions that the proposed redemption limit provision was designed to address, while also addressing the duplicative fee and complex structure concerns that underlie section 12(d)(1)(A).

a. Proposed Redemption Limit and Disclosure Requirements

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 (the "redemption limit").[174] The proposed redemption limit was designed to address concerns that an acquiring fund could threaten large-scale redemptions as a means of exercising undue influence over an acquired fund and would have limited an acquiring fund's ability to quickly redeem or tender a large volume of acquired fund shares.[175] The Commission proposed the redemption limit believing it would (along with the

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173 *See infra* footnotes 259 through 276 and accompanying text.

174 Proposed rule 12d1-4(b)(2).

175 *See* 2018 FOF Proposing Release, *supra* footnote 6, at section II.C.2 (explaining that we proposed to permit funds to purchase up to 25% of an acquired fund (or more when the funds are part of the same group of investment companies) in reliance on the rule, in part, because of the protections afforded by limiting the acquiring fund's ability to influence the fund through the threat of large-scale redemptions).

proposed control and voting conditions) address the same concerns regarding undue influence and overreaching that the conditions currently found in the exemptive orders sought to address, without requiring procedures and related board findings covering particular instances where undue influence and overreaching could exist. The Commission stated that replacing these conditions with the proposed redemption, control, and voting conditions could lower compliance costs and burdens and enhance investor protection for acquired funds.

Many commenters opposed the proposed redemption limit.[176] These commenters raised a number of concerns, including: (1) operational or administrative challenges; (2) the redemption limit's potential effects on the acquiring fund's investment objectives and its ability to respond timely to changing economic or market conditions; (3) the impact on competition and innovation; (4) whether funds in the same group of investment companies should be subject to the requirements; (5) concerns relating to liquidity; and (6) the cost of the proposed limits.[177] These commenters offered a number of alternatives in lieu of the proposed redemption limit.[178] We also received a number of comments on a proposed disclosure requirement relating to the redemption limit.[179]

Operational and administrative challenges. Commenters stated that the proposed redemption limit would present a number of operational or administrative challenges, including

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176 *See, e.g.*, ICI Comment Letter; Morningstar Comment Letter. Some commenters did support specific elements of the proposed limit. *See, e.g.,* MFA Comment Letter (supporting the approach that the limit not apply to sales of fund shares in secondary market transactions).

177 *See, e.g.,* ICI Comment Letter; Fidelity Comment Letter; Comment Letter of John Hancock Investments (May 2, 2019) ("John Hancock Comment Letter").

178 *See, e.g.,* Comment Letter of The Vanguard Group, Inc. (May 2, 2019) ("Vanguard Comment Letter"); Comment Letter of Fidelity Rutland Square Trust II (May 2, 2019) ("Fidelity Rutland Comment Letter").

179 *See, e.g.,* SIFMA AMG Comment Letter; Fidelity Comment Letter; PGIM Comment Letter.

disrupting existing fund of funds arrangements.[180] Many commenters provided evidence that the proposed redemption limit would have a large effect on funds.[181] For example, one commenter provided survey results showing that, in the past three years, 228 fund of funds arrangements conducted 1,399 redemption transactions in excess of 3%.[182] One commenter stated that, in the case of large-scale redemptions, an acquiring fund may have difficulty meeting redemption requests from its own shareholders in light of this limit, in part because making in-kind distributions to its shareholders would be difficult on such a large scale.[183] Other commenters questioned whether this requirement was consistent with the requirements of the Act, including section 22(e) which generally prohibits registered investment companies from suspending the right of redemption of redeemable securities.[184]

Some commenters discussed the challenges associated with tracking the outstanding voting securities of numerous third-party funds for investment threshold and redemption limit percentages over rolling 30-day periods, noting that this information is not readily available to the investing public.[185] Another commenter stated that it may be challenging to build compliance system enhancements that can account for multiple redemptions within any rolling

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180 *See, e.g.*, ICI Comment Letter; Guggenheim Comment Letter; Capital Group Comment Letter; SIFMA AMG Comment Letter; Fidelity Comment Letter; Dechert Comment Letter; Ropes Comment Letter; Comment Letter of the Independent Directors Council (May 1, 2019 ("IDC Comment Letter").

181 *See, e.g.*, Comment Letter of JP Morgan Asset Management (May 2, 2019) ("JP Morgan Comment Letter"); Comment Letter of Allianz Investment Management LLC (May 1, 2019) ("Allianz Comment Letter"); Vanguard Comment Letter. *See* 2018 FOF Proposing Release, *supra* footnote 6, at n.125 and accompanying text.

182 *See* ICI Comment Letter.

183 *See* Fidelity Comment Letter. *See also* ABA Comment Letter; Ropes Comment Letter.

184 *See* TRP Comment Letter; Fidelity Comment Letter. *See also* Dimensional Comment Letter; NYC Bar Comment Letter (questioning whether the Commission was, in effect, redefining "redeemable security" under the Act).

185 *See, e.g.*, Fidelity Comment Letter; Ropes Comment Letter.

30-day period and apply those calculations to outstanding share balances that change daily.[186] Some commenters stated that these challenges would cause portfolio management teams to reduce exposures to acquired funds as their holdings approach the 3% limit as a means to mitigate these challenges.[187] Other commenters stated that the proposed redemption limit could prevent an acquiring fund from timely participating in certain transactions, such as liquidations or mergers of the acquiring fund, even where the acquiring fund's board and/or its shareholders have approved such transactions.[188]

Potential impacts on investment strategies. Several commenters expressed the view that the proposed redemption limit could impede acquiring funds' ability to follow their investment strategy.[189] Commenters stated that portfolio managers routinely change allocations among underlying funds in response to economic or market conditions, or in keeping with the stated investment strategy of the fund of funds, and that redemption limits could prevent portfolio managers from making such changes in a timely fashion.[190] For example, some commenters noted that the proposed redemption limit would prevent or limit portfolio managers' ability to make investment changes when they identify an underlying fund as underperforming or no longer meeting the needs of the investment strategy of the fund of funds.[191] One commenter stated that the proposed redemption limit could force acquiring funds and their shareholders to

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186 *See* TRP Comment Letter.

187 *See* Dechert Comment Letter; JP Morgan Comment Letter.

188 *See* Allianz Comment Letter; John Hancock Comment Letter.

189 *See, e.g.,* SIFMA AMG Comment Letter (providing survey results suggesting the proposed rule would have "a significant impact on the fund of funds business"); CFA Comment Letter (stating that the proposed redemption limit would inappropriately lock fund of funds investors into funds that no longer serve their best interests for unreasonable amounts of time).

190 *See, e.g.*, Comment Letter of Nationwide Funds Group (Apr. 26, 2019) ("Nationwide Comment Letter"); Invesco Comment Letter; PIMCO Comment Letter; CFA Comment Letter.

191 *See* Nationwide Comment Letter; Vanguard Comment Letter; Dimensional Comment Letter.

hold onto underlying funds that underperform, have higher costs than alternatives that become available, or no longer achieve the fund's strategy.[192] Another commenter suggested that to comply with the proposed redemption limit, some funds may alter an acquiring fund's investment strategy to invest in different affiliated or unaffiliated acquired funds to avoid owning more than 3% of any acquired fund, which could frustrate the investment expectations of shareholders, and may increase the costs and complexity of the fund.[193] Other commenters noted that this restriction would force acquiring fund portfolio managers to liquidate other positions to meet redemption requests.[194] Another raised concerns as to whether the limit would impair rebalancing and restructuring transactions that may involve redemptions beyond the 3% limit.[195]

Impact on competition and innovation. Several commenters stated that requiring acquiring funds to redeem large positions slowly over time could place acquiring fund shareholders at a substantial competitive disadvantage to investors that are not subject to the same restrictions.[196] One of these commenters also stated that the redemption limit would encourage consolidation, raise barriers to entry for new fund managers, and limit investment options for investors.[197] Many commenters stated that the limitation would have an adverse

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192 *See* CFA Comment Letter. *See also* Voya Comment Letter.

193 *See* Allianz Comment Letter.

194 *See* TRP Comment Letter; Dechert Comment Letter; Ropes Comment Letter.

195 *See* Vanguard Comment Letter.

196 *See, e.g.*, JP Morgan Comment Letter; SIFMA AMG Comment Letter (arguing that retail investors may be unfairly disadvantaged because their exposure to acquired funds through a fund of funds would be subject to the proposed redemption limit, while other investors who directly invested in an acquired fund would not be so limited and therefore would be able to access liquidity with priority over acquiring fund investors); Fidelity Comment Letter.

197 *See* Dechert Comment Letter.

impact upon smaller funds, in part because the 3% limit would be easier to cross with such funds.[198] Others asserted that it would adversely impact target-date funds.[199]

Other commenters focused on the proposed redemption limit's impact on fund innovation. For example, one commenter stated that the redemption limit could inhibit the formation of new investment products, such as funds intended to serve as underlying funds for other funds in the same group of investment companies, because a sufficient number of investors would not hold the new product to avoid triggering the 3% limit.[200] Similarly, a commenter raised concerns that the proposed redemption limit could discourage acquiring funds from exposure to non-traditional asset classes, which often have more volatile in- and out-flows and smaller asset bases, resulting in a less desirable mix of assets made available to investors.[201] This commenter stated that if the proposed redemption limit discourages an acquiring fund from investing in an acquired fund, this could reduce overall economies of scale and operational efficiencies of the acquired fund or even challenge its viability.

Some commenters predicted that the proposed redemption limit would have a chilling effect on acquiring funds using mutual funds in their allocations and would effectively codify the limits set forth in sections 12(d)(1)(A) and (B) of the Act as the maximum investment in unrelated acquired funds.[202] Other commenters indicated that acquiring funds would restructure

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198 *See, e.g.,* PIMCO Comment Letter; IDC Comment Letter; Voya Comment Letter; Chamber of Commerce Comment Letter.

199 *See, e.g.,* Morningstar Comment Letter; IAA Comment Letter; Comment Letter of Fidelity Fixed Income and Asset Allocation Funds (May 2, 2019) ("Fidelity Fixed Income Trustees Comment Letter"); Nuveen Comment Letter; ABA Comment Letter.

200 *See* Comment Letter of Russell Investment Management, LLC (May 3, 2019) ("Russell Comment Letter"). *See also* Comment Letter of Mutual Fund Directors Form (May 2, 2019) ("MFDF Comment Letter") (stating that the proposed limit may limit the desire of acquiring funds to buy large stakes in acquired funds, thus disincentivizing innovation).

201 *See* Voya Comment Letter.

202 *See* Capital Group Comment Letter.

to avoid the proposed redemption limitation, including investing in a larger number of funds in order to hold smaller proportions of each acquired fund, or relying more on ETFs.[203]

Same group of investment companies. Several commenters questioned the need for applying the proposed redemption limit to acquiring funds investing in acquired funds in the same group of investment companies, stating that it would be unnecessary and inappropriate to do so.[204] Some of these commenters highlighted that the proposed rule included exceptions from the voting and control provisions for funds in the same group of investment companies and stated that a similar exception should be included from the redemption limit.[205] One commenter argued that the proposed redemption limit could pose particular challenges for common fund of funds arrangements involving funds within the same group, such as when an acquired fund is exclusively available to acquiring funds managed by the same adviser. As a result, these commenters asserted there would be no colorable risk that the acquiring fund would threaten redemptions to exert undue influence.[206] Another commenter stated that, for affiliated fund of funds arrangements, the common investment adviser's fiduciary duties to both the acquiring and acquired funds would adequately address duplicative and excessive fee concerns.[207]

Liquidity. Commenters also identified a number of concerns regarding the proposed redemption limit's impact upon the liquidity of the acquiring fund's portfolio. A number of commenters thought that this aspect of the proposal would increase the difficulty of complying

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203 *See, e.g.,* ABA Comment Letter; Comment Letter of Chapman and Cutler LLP (May 2, 2019) ("Chapman Comment Letter"); Morningstar Comment Letter; Capital Group Comment Letter.

204 *See, e.g.,* Allianz Comment Letter; Fidelity Fixed Income Trustees Comment Letter.

205 *See, e.g.,* PIMCO Comment Letter; Wells Fargo Comment Letter; Chapman Comment Letter.

206 *See* Fidelity Fixed Income Trustees Comment letter (arguing that there is no colorable risk of using the threat of redemptions to bully third-party investors in, or advisers to, such affiliated underlying funds).

207 *See* SIFMA AMG Comment Letter.

with rule 22e-4 by potentially impacting the liquidity categorization of an acquired fund's shares.[208] Some commenters stated that the proposed restriction would impose liquidity constraints on funds, which could become more pronounced if a particular acquired fund is under redemption pressures.[209] Other commenters discussed the impact of the proposed restriction on fund liquidations.[210]

Cost. Commenters also raised concerns over increased costs and expenses because of the proposed limit. Several commenters stated that the proposed redemption limit would increase compliance costs because of the burden of monitoring the 3% threshold.[211] One commenter thought portfolio management costs would increase if an adviser could not effect a particular strategy through a fund due to the redemption limit.[212] Some commenters suggested that acquiring funds with a limited number of acquired funds might restructure to a "sleeved" approach—*i.e.*, funds historically organized as funds of funds, rather than investing in acquired funds, would instead hire various sub-advisers to manage directly specified assets of the fund, thus increasing costs.[213] Some commenters also noted that the proposed limit would result in

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208 *See, e.g.,* MFDF Comment Letter; Wells Fargo Comment Letter; Capital Group Comment Letter (suggesting alternatives on how to consider acquired fund shares under the proposed redemption limit for rule 22e-4 purposes); Dechert Comment Letter.

209 *See, e.g.,* ABA Comment Letter; Fidelity Comment Letter (noting that the acquiring fund could be required to remain invested in an acquired fund facing a crisis such as fraud or bankruptcy whereas other investors would be able to redeem).

210 *See* Invesco Comment Letter; Chapman Comment Letter; Schwab Comment Letter.

211 *See, e.g.*, TRP Comment Letter; NYC Bar Comment Letter; Ropes Comment Letter. *See* 2018 FOF Proposing Release, *supra* footnote 6, at section II.C.2.

212 *See* Guggenheim Comment Letter. *See also* Fidelity Comment Letter (discussing the potential for managed account programs to move to direct fund investments, rather than fund of funds).

213 *See* Allianz Comment Letter; Fidelity Comment Letter (stating such an approach could increase costs related to screening, due diligence, and ongoing monitoring and oversight, and would increase the oversight responsibilities and workload of the funds' boards of directors, estimating that the number of sub-advisers overseen by the funds' boards would approximately triple).

significant transaction costs as the acquiring funds restructure their investment strategies and portfolios.[214]

Alternatives. Some commenters suggested alternatives to the proposed redemption limit.[215] For example, some commenters suggested that the proposed redemption limit exclude fund of funds arrangements that involve funds in the same group of investment companies or are otherwise affiliated, stating that there is minimal risk of undue influence by an acquiring fund over an acquired fund within the same group of investment companies.[216] Another suggested an exception for fund liquidations,[217] and another suggested an exception for redemptions that merely facilitate redemption requests from the acquiring fund's shareholders.[218] Other commenters questioned the need to replace the conditions in the existing exemptive orders.[219] Some suggested that the rule permit funds to rely either on existing exemptive relief or the rule, or that the Commission codify existing relief in a rule, so that funds with existing relief would not have to comply with the proposed redemption limit.[220]

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214 *See* Wells Fargo Comment Letter; Fidelity Comment Letter.

215 *See, e.g.,* Vanguard Comment Letter; Fidelity Rutland Comment Letter; Dimensional Comment Letter.

216 *See, e.g.*, Invesco Comment Letter; Allianz Comment Letter; Thrivent Comment Letter.

As discussed in more detail below, we are not exempting funds within the same group of investment companies from the fund of funds investment agreement requirement in the rule as adopted because, among other things, these funds can have different advisers and different boards. *See infra* text accompanying footnote 364.

217 *See* Invesco Comment Letter.

218 *See* NYC Bar Comment Letter.

219 *See, e.g.,* ICI Comment Letter; IDC Comment Letter; MFDF Comment Letter.

220 *See, e.g.*, Fidelity Rutland Comment Letter; John Hancock Comment Letter (further suggesting that the adviser, rather than the fund, be responsible for monitoring and oversight, subject to board reporting).

Some commenters suggested making the redemption requirement permissive,[221] letting the funds determine the size of permissible redemptions,[222] increasing the percentage of shares that could be redeemed,[223] or providing a shorter time period to align the applicable time period with rule 22e-4.[224] Others questioned the need for redemption limits at all to protect acquiring funds' investment in unaffiliated acquired funds, particularly given the existence of other protections in rule 12d1-4 and elsewhere (such as other regulations or existing fiduciary obligations).[225] Some commenters suggested that we exempt in-kind redemptions from the requirement.[226]

Other commenters stated that participation agreements, either consistent with existing Commission orders or altered in various ways, could be an alternative to the proposed redemption limit because they would provide opportunities for acquired funds to protect their interests, while preserving the benefits of fund of funds structures for shareholders.[227] As

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221 *See, e.g.,* Invesco Comment Letter; Comment Letter of MFS Investment Management (May 2, 2019) ("MFS Comment Letter"); BlackRock Comment Letter.

222 *See* Schwab Comment Letter; *see also* John Hancock Comment Letter (suggesting to exempt situations where the acquiring fund goes over 3% as a result of the decrease in the outstanding securities of the acquired fund from the proposed limit).

223 *See* NYC Bar Comment Letter.

224 *See* BlackRock Comment Letter.

225 *See, e.g.,* PIMCO Comment Letter; BlackRock Comment Letter.

226 *See* Comment Letter of Thrivent Financial for Lutherans (May 1, 2019) ("Thrivent Comment Letter"); Ropes Comment Letter (stating that the ability of an acquired fund to satisfy redemption requests in-kind mitigates undue influence concerns).

227 *See* NYC Bar Comment Letter (suggesting a redemption management agreement); ICI Comment Letter (suggesting a simplified participation agreement); Federated Comment Letter; PIMCO Comment Letter; John Hancock Comment Letter (suggesting that, instead of a participation agreement, each fund receive reciprocal written acknowledgment that the funds would be relying upon, and comply with, the rule); Advent Comment Letter (arguing that the rule should require funds to enter into a participation agreement if the investment is more than 10% of the acquired fund's voting securities); IDC Comment Letter; Vanguard Comment Letter (suggesting a framework of acquiring fund advisers making a best interest finding and then entering into a participation agreement); Dimensional Comment Letter; Fidelity Rutland Comment Letter; Wells Fargo Comment Letter; Capital Group Comment Letter; Fidelity Comment Letter; Dechert Comment Letter; IAA Comment Letter; Nationwide Comment Letter. *But see* BlackRock Comment Letter (arguing against the inclusion of participation agreements in the final rule).

support for this framework, one commenter suggested that the acquiring fund's investment adviser certify to the acquired fund's investment adviser that it will not invest in the acquired fund as a means to exert undue influence over the acquired fund or to influence any services or transactions and notify the acquired fund if its investment exceeds the limits in section 12(d)(1)(A).[228] This commenter also suggested that the rule require periodic reporting to each of the acquiring and acquired funds' board of directors.

Another commenter suggested that the final rule require participation agreements that are approved by each of the acquiring and acquired funds' board of directors,[229] although others stated that the board should not be required to be involved in approving fund of funds arrangements.[230] This commenter suggested requiring board review, at least annually, of all transactions between the acquired fund and affiliates of the acquiring funds to determine whether the acquiring funds have influenced the transactions.[231] The commenter also suggested that the rule allow acquired funds and their boards, at their option, to set their own limit for an acquiring fund's investment. Another commenter stated that participation agreements operate efficiently and effectively to prevent undue influence and are an effective alternative to the proposed redemption limit.[232] Other commenters stated that one of the key elements of a participation agreement is the ability for the acquired fund to refuse to enter into the participation agreement,

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228 *See* Vanguard Comment Letter.

229 *See* Dimensional Comment Letter. While we are not requiring that fund boards approve fund of funds arrangements, we will require reporting to boards to facilitate their oversight function. *See infra* footnotes 314 through 320 and accompanying text.

230 *See* ICI Comment Letter; Voya Comment Letter; Invesco Comment Letter.

231 *See* Dimensional Comment Letter.

232 *See* Fidelity Rutland Comment Letter.

which prevents the acquiring fund from investment in the acquired fund beyond the limits set forth in section 12(d)(1)(A).[233]

Another commenter stated that the proposed limit was unnecessary because funds frequently negotiate large-scale redemptions to minimize any impacts that would result in undue influence.[234] One commenter stated that funds can manage the threat of undue influence from large-scale redemptions by delaying payment for up to seven days where immediate payment would harm the fund.[235] Others suggested that the Commission require pre-notification of large trades as an alternative to the limit.[236]

Commenters suggested a number of other alternatives to the proposed redemption limit. One commenter suggested that we limit the overall percentage of acquired fund shares that an acquiring fund could own to 20%.[237] Another recommended a policies and procedures-based system to ensure that the acquiring fund's adviser acts in the acquiring fund's best interest.[238] Others suggested that, if the Commission retained the proposed redemption limit, we also retain rule 12d1-2.[239] One suggested that the Commission replace the real-time tracking that would

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233 *See* Chapman Comment Letter; Dimensional Comment Letter.

234 *See* John Hancock Comment Letter. *See also* JP Morgan Comment Letter (stating that, in its experience, large investors are amenable to procedures designed to facilitate careful redemptions, which typically are in all parties' interests).

235 *See* Fidelity Comment Letter. This commenter also noted that, as a practical matter, two-day settlement requirements under 17 CFR 240.15c6-1 effectively take most fund investments to a T+2 settlement timeline.

236 *See* Schwab Comment Letter; JP Morgan Comment Letter.

237 *See* John Hancock Comment Letter.

238 *See* SIFMA AMG Comment Letter.

239 *See* Nuveen Comment Letter; Vanguard Comment Letter (further recommending that rule 12d1-2 be expanded to non-securities); Russell Comment Letter.

have been required to satisfy the proposed redemption limit with an allowance to rely upon the shares listed in the acquired fund's most recently published financial statements.[240]

Disclosure. In connection with the proposed redemption limit, we also proposed that a fund relying on rule 12d1-4 would be required to disclose in its registration statement that it is (or at times may be) an acquiring fund for purposes of the proposed rule.[241] This disclosure requirement was intended to put other funds seeking to rely on rule 12d1-4 on notice that a fund they seek to acquire is itself an acquiring fund, and therefore to allow a fund to limit its acquisition of the acquiring fund's securities accordingly.

Commenters generally opposed the disclosure requirement, predicting that funds would prophylactically disclose that they may rely upon the rule, and that acquired funds would not be able to monitor continuously the disclosure of potential acquired funds.[242] Further, commenters suggested that such an approach could reduce the number of funds willing to become acquired funds and create fewer investment opportunities for funds of funds.[243] As an alternative, a commenter recommended that acquiring funds disclose a principal investment strategy of investing in other funds, or allow funds to rely on a representation in a participation

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240 *See* NYC Bar Comment Letter.

241 *See* proposed rule 12d1-4(b)(4).

242 *See, e.g.,* SIFMA AMG Comment Letter; Fidelity Rutland Comment Letter; Skadden Comment Letter. However, a few commenters did suggest enhanced disclosure, including an expansion of this disclosure requirement, in lieu of other proposed requirements. *See* Comment Letter of Massachusetts Mutual Life Insurance Company (May 2, 2019) ("MassMutual Comment Letter") (with regard to private funds); Ropes Comment Letter; Nationwide Comment Letter (with regard to the proposed redemption limit).

243 Fidelity Comment Letter.

agreement.[244] One commenter suggested that the Commission provide for alternative disclosures for BDCs and other closed-end funds.[245]

b. Fund Findings and Fund of Funds Investment Agreement

After considering the comments received, we have determined not to adopt the proposed redemption limit or require funds to disclose whether they are (or at times may be) an acquiring fund for purposes of the rule.[246] Instead, we are adopting a combination of conditions that we believe will protect investors in fund of funds arrangements from the concerns the proposed redemption limit sought to address and will provide the notice that the proposed disclosure requirements would have provided. Specifically, the 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; (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;[247] and (iii) both the acquiring and acquired funds to enter into a fund of funds investment agreement to memorialize the terms of the arrangement (including terms that serve as a basis for the required findings) when the acquiring and acquired

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244 Fidelity Comment Letter. One commenter also suggested that investor confusion concerns could be mitigated by an acquired fund's adviser, including with an assurance regarding its disclosure in its report to the acquired fund's board. TRP Comment Letter. *See infra* Section II.C.2.c (discussing the board reporting requirements).

245 *See* BlackRock Comment Letter.

246 We are, as proposed, amending N-CEN to require reporting when an acquired fund has holdings in other funds. *See infra* Section III.

247 The final rule refers to "fees and expenses" in a number of places where the proposed rule only referred to "fees." *Compare* rule 12d1-4(b)(2)(i)(A) *with* proposed rule 12d1-4(b)(3)(i). In the 2018 FOF Proposing Release, when we discussed fees, we mentioned a number of "fees" that may more appropriately be characterized as "expenses." *See* 2018 FOF Proposing Release, *supra* footnote 6, at 61 (discussing fees for recordkeeping, sub-transfer agency services, sub-accounting services, or other administrative services). In order to avoid confusion, we have revised the relevant provisions to refer to both fees and expenses, not just fees.

fund do not share an investment adviser. The rule's requirements vary based on the structural characteristics of the funds involved in the arrangement, but seek the same goal of avoiding the historical abuses that section 12(d)(1) was intended to prevent.[248]

The Commission proposed the redemption limit believing that it would be more effective and less burdensome than conditions set forth in our orders.[249] Commenters provided additional context and information regarding the impact of the proposed limit, suggesting that the proposed redemption limit would have a larger impact on fund of funds arrangements and would be more burdensome than the Commission contemplated in the proposal. We believe that our adopted approach expanding the proposed finding requirement will address undue influence concerns more effectively and with less disruption to current market practices than the proposed redemption limit (or the conditions in our existing exemptive orders) and will more effectively put funds on notice that a fund they seek to acquire is itself an acquiring fund.[250]

i. Evaluations and Findings for Management Companies[251]

Under the final rule, a fund's investment adviser will be required to make certain evaluations and findings that are tailored to the specific concerns that underlie section

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248 The Fund Findings requirement will apply regardless of the form and structure of the other fund acquired by or acquiring the fund in question. Thus, an adviser to an acquiring fund that is a management company would still need to make its finding with respect to the acquiring fund even if the acquired fund is, for example, a UIT (which will not need its own Fund Finding under the rule).

249 The conditions in our orders generally require fund boards to make certain findings and, for investments in unaffiliated funds, adopt procedures to prevent overreaching and undue influence by the acquiring fund and its affiliates once the investment in an unaffiliated acquired fund exceeds the section 12(d)(1) limit. *See* 2018 FOF Proposing Release, *supra* footnote 6, at n.117 and accompanying text.

250 For example, the fund of funds investment agreement discussed below will allow the acquired fund to screen potential acquiring fund investments, thereby addressing the notice concern enumerated in the proposal. *See* 2018 FOF Proposing Release, *supra* footnote 6, at 79.

251 The term "management companies" includes BDCs. *See generally* 15 U.S.C. 80a-4 (defining "management company" as an investment company other than a face amount certificate company or UIT) and 15 U.S.C. 80a-58 (providing that, among other things, 15 U.S.C. 80a-4 applies to a BDC to the same extent as if it were a registered closed-end investment company).

12(d)(1).[252] For management companies that are acquired funds, rule 12d1-4 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.[253] These factors are (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. These factors are designed to focus the analysis of an acquired fund's adviser on potential ways to reduce the threat of undue influence, including through redemptions, when an acquiring fund invests in the acquired fund beyond the section 12(d)(1) limits under the rule. Because concerns regarding undue influence are more salient for acquired funds, only the adviser to an acquired fund will be required to make this determination.

In cases where the acquiring fund is a management company, rule 12d1-4 will require the management company'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.[254] 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

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[252] *See supra* footnotes 17 and 18 and accompanying text.

[253] Rule 12d1-4(b)(2)(i)(B).

[254] Rule 12d1-4(b)(2)(i)(A).

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.[255]

As discussed in more detail below,[256] the rule will also require the acquiring fund and acquired fund to enter into a fund of funds investment agreement for the duration of the funds' reliance upon the rule to memorialize the terms of the agreement, unless the funds share the same investment adviser. The agreement must include any material terms necessary to make the appropriate Fund Finding.[257] The final rule will provide funds with flexibility to consider—and where appropriate to negotiate and agree to as part of the fund of funds investment agreement—terms designed to protect investors and address the concerns underlying section 12(d)(1)(A).

The Fund Findings must be made, and the fund of funds investment agreement entered into, before the acquiring fund invests in the acquired fund in reliance on the rule. Consistent with the proposal, the rule also will require the adviser to report its evaluation, finding, and the basis for its evaluation or finding to the acquiring fund's board of directors. This report will not be required until the next regularly scheduled board of directors meeting.[258]

Changes from the Proposal. The Fund Findings for management companies as adopted differ from the finding requirement that we proposed in a few respects. First, the proposed finding requirement would have required the adviser of an acquiring fund to, after an evaluation of the complexity of the structure and aggregate fees and expenses associated with the acquiring

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255 *See supra* footnote 38. *See also* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248 (Jun. 5, 2019) [84 FR 33669 (July 12, 2019)] ("Fiduciary Duty Interpretation") ("The duty of care includes, among other things: (i) the duty to provide advice that is in the best interest of the client, (ii) the duty to seek best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades, and (iii) the duty to provide advice and monitoring over the course of the relationship").

256 *See infra* Section II.C.4.c.

257 Rule 12d1-4(b)(2)(iv)(A).

258 Rule 12d1-4(b)(2)(i)(C).

fund's investment in the acquired fund, determine that the investment is in the best interest of the acquiring fund.[259] As adopted, the rule will instead require that the acquiring fund's adviser, after a similar evaluation,[260] determine that the acquiring fund's fees and expenses do not duplicate the fees and expenses of the acquired fund.[261] In the 2018 FOF Proposing Release, we had sought comment on whether we should require a best interest determination and whether we should require the determination be made on a basis of the reasonableness of fees.[262] We have made this change in part based upon comments that we received in response to this request that the concept of "best interest" in this context was unclear or overly broad,[263] and that we should instead require advisers to make their determinations based upon specific elements including whether the fees are duplicative.[264] While some commenters approved, and even recommended that we expand the use, of the best interest standard,[265] we believe that focusing an adviser's analysis under this provision upon an evaluation of the complexity of the fund of funds structure and a determination regarding whether fees and expenses are duplicative will be more effective in mitigating overly complex structures and duplicative fees and expenses.

Second, the proposed finding requirement for management companies would have applied only to acquiring funds, not to acquired funds. As adopted, the rule will additionally

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259 Proposed rule 12d1-4(b)(3)(i).

260 Consistent with this change, the final rule will require both this evaluation and the finding regarding fees and expenses, as well as the basis for these two items, be reported to the board. Rule 12d1-4(b)(2)(i)(C).

261 Rule 12d1-4(b)(2)(i)(A).

262 2018 FOF Proposing Release, *supra* footnote 6, at Section II.C.3.

263 *See* ICI Comment Letter; CFA Comment Letter; NYC Bar Comment Letter.

264 *See* NYC Bar Comment Letter; ICI Comment Letter. *See also* Fidelity Fixed Income Trustees Comment Letter (noting that, in their experience, the adviser to the acquiring fund only charges fees if the fees are not duplicative). *But see* Dechert Comment Letter (recommending that the finding requirement not include any factors).

265 *See* SIFMA AMG Comment Letter.

require a finding by advisers to acquired funds with a specific set of factors tailored to the concerns of an acquired fund.[266] The principal goal of the proposed redemption limit was to protect acquired funds from the threat of undue influence due to large-scale redemptions.[267] A number of commenters suggested that there were more appropriate ways to protect acquired funds from this concern.[268] Among these were suggestions that the adviser to an acquired fund make an evaluation similar to that of an acquiring fund.[269] We agree that this analysis, coupled with the fund of funds investment agreement as discussed below, is better suited to protect against this risk in that it avoids unduly impeding portfolio management or liquidity risk management while utilizing the acquired fund's adviser to assess the risks of undue influence presented by the investment, taking into account the enumerated factors.[270]

Third, the proposed rule would have required that the acquiring fund's adviser report its finding and the basis thereof to the acquiring fund's board of directors. Because the initial finding itself would have to be made prior to investing in an acquired fund in reliance on the rule, commenters were confused as to whether the investment could be made before this initial report to the board was made.[271] One commenter suggested we clarify that the adviser need not

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266 Rule 12d1-4(b)(2)(i)(B).

267 2018 FOF Proposing Release, *supra* footnote 6, at section II.C.2 ("To address concerns that an acquiring fund could threaten large-scale redemptions as a means of exercising undue influence over an acquired fund, the proposed rule includes a condition that would limit an acquiring fund from quickly redeeming or tendering a large volume of acquired fund shares").

268 *See supra* footnotes 215 to 240 and accompanying text.

269 *See* ICI Comment Letter; Voya Comment Letter; Vanguard Comment Letter. *But see* Dechert Comment Letter (stating that portfolio managers should be given flexibility and not subject to specific factors).

270 *See also infra* footnote 296 and accompanying text.

271 *See* NYC Bar Comment Letter; ABA Comment Letter; Dechert Comment Letter (suggesting that we not require board reporting as it will limit the ability of portfolio managers to make timely portfolio adjustments).

report until the next regularly scheduled board meeting.[272] We agree with this commenter, and are clarifying in the final rule that, while the adviser must complete the applicable Fund Findings (and fund of funds investment agreement) prior to initial investment, the adviser must report no later than the next regularly scheduled board meeting.[273]

Fourth, the proposed rule would have required the acquiring fund's adviser to make a finding both prior to the initial investment and with such frequency as the acquiring fund's board deems to be reasonable and appropriate thereafter, but in any case no less frequently than annually. We requested comment on whether we should prescribe the frequency of these determinations, and some commenters suggested that we not mandate a specific frequency.[274] However, some commenters suggested the Commission adopt the same or more frequent assessment and reporting frequency that we proposed in recommending their own alternatives to the proposed redemption limit,[275] and one recommended that we retain ongoing reporting but on a discretionary basis.[276] We agree that mandating ongoing assessments and reporting is unnecessary, particularly in light of other reporting and oversight mechanisms, such as rule 38a-1 under the Investment Company Act, which requires a fund's chief compliance officer to provide an annual written report to the board. As a result, the final rule will require an adviser to report the applicable Fund Findings to the board once; subsequent reporting regarding these Fund Findings will be conducted at least annually under the fund's compliance program. In

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272 *See* NYC Bar Comment Letter.

273 Rule 12d-1(b)(2)(i)(C). As this requirement, as adopted, includes both evaluations and findings, the rule will also require reporting regarding evaluations and the basis for evaluations.

274 *See* ABA Comment Letter; Dechert Comment Letter. *See also* NYC Bar Comment Letter (opining that the CCO's role under rule 38a-1 obviates the need for advisers to report to fund directors on all proposed investments).

275 *See* ICI Comment Letter; John Hancock Comment Letter.

276 *See* NYC Bar Comment Letter. *See also* ABA Comment Letter (stating that fund boards should be able to select their desired reporting frequency and that the rule should not mandate a minimum frequency).

addition, we do not believe it is necessary to prescribe additional requirements given the board's oversight role over fund operations.[277]

Additional Comments Received on Findings Requirement. Commenters generally supported a condition that required the investment adviser of the acquiring fund to review and consider the appropriateness of the fund of funds arrangement.[278] As noted above however, commenters suggested a number of modifications to the proposed condition, including changes to or elimination of the proposed best interest determination.[279] Some commenters suggested that we require no specific best interest determination.[280] One commenter stated that these determinations are implicit in the investment management duties of an investment adviser.[281] Another commenter stated that the Commission should provide guidance, in lieu of a best interest determination, that sets forth factors that an investment adviser should consider before investing in an acquired fund.[282]

Commenters disagreed, however, on whether the proposed best interest determination would be too flexible or not flexible enough. For example, one commenter agreed with the proposed requirements for investment advisers, but stated that the proposed requirements would not prevent fund of funds arrangements from charging duplicative fees.[283] This commenter

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277 *See* Compliance Rule Adopting Release, *supra* footnote 59 ("A fund's board plays an important role in overseeing fund activities to ensure that they are being conducted for the benefit of the fund and its shareholders").

278 *See, e.g.*, SIFMA AMG Comment Letter (stating the "adviser to an acquiring fund, rather than the acquiring fund's board, should be the party primarily responsible for entering into and monitoring fund of funds arrangements"); Invesco Comment Letter.

279 *See, e.g.*, PGIM Comment Letter; ABA Comment Letter; NYC Bar Comment Letter.

280 *See, e.g.*, ABA Comment Letter; NYC Bar Comment Letter.

281 *See* ABA Comment Letter.

282 *See* NYC Bar Comment Letter.

283 *See* CFA Comment Letter; *but see* PGIM Comment Letter (arguing that the rule should not require fee waivers because a fund board of directors is already required to evaluate the terms of advisory agreements,

suggested that the proposed best interest finding and the evaluation standards are too flexible, and that the Commission should interpret "best interest" to mean "the best of the reasonably available options." The commenter also suggested that the Commission explicitly require advisers to waive duplicative fees. Conversely, another commenter agreed with the proposed best interest requirement, but stated that the proposed factors on which the finding would be based on were not flexible enough.[284] This commenter suggested that we permit the investment adviser to consider any factors that it deems relevant in its best interest finding, including subjective factors relating to investment merits.[285]

One commenter recommended expanding the proposed best interest determination to take into account fees, complexity, investment characteristics, fund size, underlying asset liquidity, asset volatility, legal structure and other characteristics.[286] Another commenter suggested that instead of the proposed best interest finding, the final rule should require the acquiring fund's investment adviser to find that the investment in the acquired fund is "appropriate in light of the complexity and aggregate fees."[287] This commenter stated that this suggestion would more closely align the requisite finding (on complexity and aggregate fees instead of the proposed best interest finding) because the information on which advisers rely in making these evaluations relates to complexity and fees.

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which encompass the finding requirements of the proposed rule).

284 *See* Dechert Comment Letter.

285 *See id*. ("[P]ortfolio managers should be given deference and afforded flexibility with respect to their consideration of factors that they deem most relevant to the proposed best interest finding, including subjective factors relating to investment merits.").

286 *See* SIFMA AMG Comment Letter.

287 *See* ICI Comment Letter.

In the 2018 FOF Proposing Release, we noted that many of the conditions relating to fee limitations required in our exemptive orders, such as fee waivers and board findings regarding fees, were redundant in light of a fund adviser's and board's fiduciary duties and statutory obligations. As a result, we did not propose to require them as part of the finding requirement.[288] A number of commenters agreed with this approach,[289] but one commenter would have required fee waivers.[290] This commenter argued that fiduciary duties are often not enough to ensure that investors are not subject to duplicative fees.[291] We are requiring specific evaluations and findings to help address this concern.[292]

After considering comments, and in conjunction with our determination to eliminate the proposed redemption limit, we are adopting a modified requirement for management companies regarding Fund Findings that is designed to address the complexity and fees associated with the fund of funds arrangement, as well as undue influence concerns, such as from the threat of large-scale redemption. However, we are also providing advisers with flexibility to tailor their analysis to these specific concerns.

This requirement will apply to all management companies, including when both funds involved are in the same group of investment companies. While we believe it is appropriate to provide an exception from the voting and control conditions under the rule for funds in the same group of investment companies, such an exception is not appropriate for the finding condition.

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288 *See* 2018 FOF Proposing Release, *supra* footnote 6, at n.146 and accompanying text.

289 *See* ICI Comment Letter; Voya Comment Letter; PGIM Comment Letter; ABA Comment Letter.

290 *See* CFA Comment Letter.

291 *See also* Comment Letter of Anonymous, (Dec. 28, 2018) (suggesting that, if an underlying fund pays a fee, these payments should be made into the assets of the acquiring fund, and that fund of funds arrangements should not be used to avoid fee limitations).

292 *See also infra* footnotes 297 to 299 and accompanying text.

For example, two management companies in the same group of investment companies could have two different advisers and two different boards satisfying their fiduciary duties to their respective shareholders. Requiring these advisers to evaluate the fund of funds arrangement separately and make the appropriate findings tracks their separate—albeit parallel—fiduciary duties. Further, this requirement also applies if both the acquiring and acquired funds have the same adviser. This approach is similar to the proposed redemption limit, which would have applied to both unaffiliated and affiliated fund of funds arrangements.

We also believe that it is appropriate to require each fund's investment adviser to make the applicable Fund Findings because whether to invest in an acquired fund to achieve a fund's investment objective, or accept any investment from an acquiring fund, is generally a question of portfolio management.[293] That said, given the conflicts of interest at issue, we believe that the rule as adopted should provide a framework for advisers to conduct their analysis. Also, as discussed below, the fund's board of directors will be required to review these arrangements as part of its oversight responsibilities.

Acquired Fund Findings. We are requiring that advisers to acquired management companies make a finding that any undue influence concerns associated with the acquiring fund's investment in the acquired fund are reasonably addressed.[294] As part of this finding, the acquired management company's investment adviser will be required to consider a specific list of non-exhaustive factors. We believe these factors will help ensure that acquired fund advisers make appropriate determinations when assessing whether a fund of funds arrangement has terms

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[293] *See* 2018 FOF Proposing Release, *supra* footnote 6, at n.140 and accompanying text.

[294] By undue influence concerns, we mean circumstances where the acquiring fund will be in a position to control the assets of the acquired fund and use those assets to enrich the acquiring fund at the expense of acquired fund shareholders. *See supra* footnote 17 and accompanying text.

that reasonably address undue influence by the acquiring fund, including through the threat of large-scale redemptions. Additionally, because this finding requirement (along with the fund of funds investment agreement) is replacing the protections that the proposed redemption limit would have provided, requiring consideration of specific factors is designed to enable the acquired fund to effectively negotiate appropriate terms regarding the acquiring fund's use of redemptions and other ways that the acquiring fund could exert undue influence over the acquired fund.

The rule does not dictate the particular terms or how acquired fund advisers must evaluate or weigh these factors because we believe that the investment adviser is in the best position to make these decisions.[295] We believe that the adviser's familiarity with a fund's investment strategies and operations will inform its ability to identify and discern the most pertinent factors and concerns related to a fund of funds arrangement. This flexibility will allow an acquired fund to establish a fund of funds arrangement that appropriately protects its own interests and those of its investors.

We believe that collectively this list of factors will assist acquired fund advisers in determining whether undue influence has been reasonably addressed. We devised these factors based upon the issues we raised in the 2018 FOF Proposing Release and as informed by comments received with regard to the proposed redemption limit.[296] This list of factors is not an

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[295] As noted above, an investment adviser has a fiduciary duty to act in the best interests of a fund it advises. *See supra* footnote 38.

[296] *See, e.g.,* Nationwide Comment Letter (suggesting that redeeming in-kind and advance notification of redemptions are common practices that funds engage in to protect against harms from possible large scale redemptions); ABA Comment Letter (suggesting that acquired funds prefer permissive limitations, such as the redemption limit in section 12(d)(1)(F)(ii), that they can negotiate with an acquiring fund). *See also* 2018 FOF Proposing Release, *supra* footnote 6, at 54 (requesting comment as to whether there should be an exception to the redemption limit for redemptions in-kind), 55 (requesting comment as to whether the redemption limit should be voluntary at the election of an acquired fund and, if so, what other safeguards

exhaustive list, and acquired fund advisers should consider anything else relevant under the circumstances when making their findings.

One commenter objected to a finding that involves an analysis of specific factors, stating that we should afford portfolio managers deference and flexibility when making an investment decision.[297] This commenter suggested that the fiduciary duties of the adviser and board are sufficient to protect against the undue influence concerns behind section 12(d)(1). Another commenter made a similar suggestion, stating that the guidance provided regarding the proposed finding requirement would add complexity, cost, and additional time to the investment process without adding significant value beyond the adviser exercising its fiduciary duty alone.[298] While we agree that an adviser acting according to its fiduciary duty helps to protect against these concerns, the factors we are adopting should help the acquired fund adviser to exercise that duty by focusing upon those issues we believe are most important for an acquired fund in assessing this risk.[299]

We believe each of the following factors is appropriate for an investment adviser to a management company to consider before making its finding:

- *Scale of investment*. The final rule will require the acquired fund's investment adviser to consider the scale of contemplated investments by the acquiring fund

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could be added to protect against undue influence), and 57 (requesting comment, if the proposed redemption limit does not appropriately limit the threat of using redemptions to exercise undue influence or control, on what other conditions would better do so).

297 *See* Dechert Comment Letter. *But see* NYC Bar Comment Letter (stating that, while it believes that a best interest determination is unnecessary, it is appropriate for the Commission to highlight areas that it believes an investment adviser should consider prior to entering into a fund of funds arrangement).

298 *See* Guggenheim Comment Letter.

299 *See also supra* footnotes 288 to 292 and accompanying text.

and any maximum investment limits.[300] For example, the investment adviser may determine that certain levels of investment by an acquiring fund in excess of the section 12(d)(1) limits would be appropriate for the acquired fund's operations. Conversely, the adviser could determine that investments above a certain level would raise undue influence concerns because of the adverse effect a large-scale redemption from one large investor (*e.g.*, 10% of the acquired fund's outstanding voting shares) could have on the fund and its investors. Assuming the funds have different advisers, the acquired fund could set the limit in the fund of funds investment agreement, or for funds with the same adviser, as part of the written record of its Fund Findings.[301] To the extent an acquiring fund exceeded the acquired fund's specified threshold, the acquired fund could terminate the fund of funds agreement as an additional means of prohibiting additional investments. Alternatively, an acquired fund's adviser may determine that such a limitation on its investment is not necessary to address reasonably undue influence by the acquiring fund through the threat of large-scale redemptions.

- *Anticipated timing of redemption requests*. The final rule will require the acquired fund's investment adviser to consider the anticipated timing of redemption requests by the acquiring fund.[302] The acquired fund's adviser could, for example, determine that the undue influence concerns regarding an acquiring fund's investment would be reasonably addressed only if the acquiring fund

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300 *See* rule 12d1-4(b)(2)(i)(B)(1).

301 *See infra* footnote 360 and accompanying text.

302 *See* rule 12d1-4(b)(2)(i)(B)(2).

commits to submitting redemption requests over multiple days. Depending on the particular investment strategy and liquidity of the acquired fund, such an adviser might consider the impact of immediate, large redemption requests and determine that the undue influence concerns would be reasonably addressed only if such requests are made over multiple days.[303]

- *Advance notification of investments or redemptions.* The final rule will require the acquired fund's investment adviser to consider whether and under what circumstances the acquiring fund will provide advance notification of investments and redemptions.[304] For example, the adviser may request or require that the acquiring fund provide advance notice of a large redemption before entering into a fund of funds investment agreement. However, any agreement related to this factor would still have to comply with section 22(e) of the Act.
- *In-kind redemptions*. The final rule requires the acquired fund's investment adviser to consider whether redemptions will be made in cash or in kind by the acquired fund.[305] For example, to facilitate redemptions or investments, the adviser may consider as part of its arrangement whether redemptions will be in

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303 Investors in mutual funds can redeem their shares on each business day and, by law, must receive approximately their pro rata share of the fund's net assets (or its cash value) within seven calendar days after receipt of the redemption request. *See* section 22(e) of the Act (providing, in part, that no registered investment company shall suspend the right of redemption, or postpone the date of payment upon redemption of any redeemable security in accordance with its terms for more than seven days after tender of the security absent unusual circumstances).

304 *See* rule 12d1-4(b)(2)(i)(B)(3).

305 *See* rule 12d1-4(b)(2)(i)(B)(5).

cash or in kind, or whether only redemptions above a certain threshold may be made in-kind.[306]

In order to make its finding, an acquired fund's adviser also would need to consider any other relevant regulatory requirements. For example, an acquired fund's consideration of the threat of undue influence through redemptions would depend in part on the fund's liquidity risk and how it manages that risk. Accordingly, the adviser to an acquired fund may need to consider how it would manage any liquidity risk from the acquiring fund's investment under its liquidity risk management program required by rule 22e-4. Terms agreed upon through assessment of the factors described above may be a part of how the acquired fund plans to manage any such liquidity risk. In other cases, the acquired fund's adviser may determine that an acquiring fund's investment does not raise a threat of undue influence through large-scale redemptions—or that any threat is addressed through the terms of the fund of funds investment agreement—but that it must take other steps through its liquidity risk management program to manage liquidity risks under rule 22e-4. In negotiating a fund of funds investment agreement, an acquired fund adviser should address all matters to the extent necessary to allow the fund to comply with legal and regulatory requirements under the Federal securities laws.

Acquiring Fund Evaluations and Findings. As we discussed in the 2018 FOF Proposing Release, the evaluations (and related finding) that we are requiring of advisers to management companies that are acquiring funds are designed to help guard against the construction of a

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[306] Many funds reserve the right to redeem their shares in-kind instead of with cash. *See, e.g.*, rule 18f-1; rule 22e-4(b)(v); Election by Open-End Investment Companies to Make Only Cash Redemptions, Investment Company Act Release No. 6561 (June 14, 1971) [36 FR 11919 (June 23, 1971)] (stating that the definition of "redeemable security" in section 2(a)(32) of the Investment Company Act "has traditionally been interpreted as giving the issuer the option of redeeming its securities in cash or in kind").

complex structure that could be confusing to the acquiring fund's shareholders and to prevent excessive layering of fund costs.[307]

In evaluating the complexity of a fund of funds structure, an acquiring fund adviser should consider the complexity of the acquiring fund's investment in an acquired fund versus direct investment in assets similar to the acquired fund's holdings. The adviser should consider whether the resulting structure would make it difficult for shareholders to appreciate the fund's exposures and risks or circumvent the acquiring fund's investment restrictions and limitations. The adviser also should consider whether an acquired fund invests in other funds, which may create additional complexity.[308]

In evaluating the fees associated with the fund's investment in acquired funds, an adviser should consider the fees of both the acquiring and acquired funds within the fund of funds arrangement with an eye towards duplication. Specifically, an adviser should consider whether the acquired fund's advisory fees are for services that are in addition to, rather than duplicative of, the adviser's own services to the acquiring fund. The adviser also should consider the other fees and expenses, such as sales charges, recordkeeping fees, sub-transfer agency services, and fees for other administrative services.

We believe the flexibility provided by the rule will allow an acquiring fund to establish a fund of funds investment agreement that appropriately protects its own interests and those of its investors. However, as with acquired fund advisers, in negotiating a fund of funds investment agreement, an acquiring fund adviser should address all matters to the extent necessary to allow the fund to comply with legal and regulatory requirements under the Federal securities laws.

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307 *Id.*

308 *Id.* at n.141 and accompanying text.

An acquiring fund board already has a responsibility to see that the fund is not being overcharged for advisory services regardless of any findings we require.[309] Section 15(c) of the Act requires the board of directors of the acquiring fund to evaluate any information reasonably necessary to evaluate the terms of the acquiring fund's advisory contracts (which information would include fees, or the elimination of fees, for services provided by an acquired fund's adviser).[310] Section 36(b) of the Act also imposes on fund advisers a fiduciary duty with respect to their receipt of compensation.[311] We believe that to the extent advisory services are being performed by another person, such as the adviser to an acquired fund, this fiduciary duty would require an acquiring fund's adviser to only charge fees or expenses for the services that the acquiring fund's adviser is providing, and not for any services performed by an adviser to an acquired fund.[312] In addition, when an adviser to an acquiring fund (or an affiliate of an adviser) receives compensation from, or related to, an acquired fund in connection with an investment by the acquiring fund, the adviser has a conflict of interest. The adviser has a fiduciary duty to the acquiring fund under the Advisers Act and must act in the best interest of its clients, including eliminating or making full and fair disclosure of this conflict.[313]

Nevertheless, we believe that it is appropriate for the rule to require that the acquiring fund's adviser find that the aggregate fees and expenses are not duplicative, given the inherent conflict of interest the adviser faces in this circumstance. This finding, which is reported to the

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309 *See* 2006 FOF Adopting Release, *supra* footnote 19, at n.52 and accompanying text.

310 15 U.S.C. 80a-15(c).

311 15 U.S.C. 80a-36(b).

312 *See* 2006 FOF Adopting Release, *supra* footnote 19, at n.52.

313 *See* Fiduciary Duty Interpretation, *supra* footnote 255.

board of directors, gives the fund's board information specific to the fund of funds arrangement to review when exercising its oversight responsibilities over the adviser.

Investment Adviser Reporting and Board Oversight. The final rule will require the adviser to a management company to report its evaluation, 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.[314] As discussed above,[315] the final rule differs from the proposed rule in that we will not additionally require the fund's board of directors to set the frequency of determination as reasonable and appropriate after the initial investment, but in any case no less frequently than annually.

Some commenters suggested that the Commission eliminate or modify the requirement that the investment adviser of the acquiring fund report the proposed best interest determination to the acquiring fund's board of directors.[316] One commenter characterized this requirement as unduly burdensome, as another mandatory report that may be complex and data heavy.[317] Rather than reporting the finding to the board of directors before investing in an acquired fund, a commenter recommended that the final rule require such reporting and the basis for the adviser's determination to the board of directors at the next regularly scheduled meeting.[318] On the other hand, one commenter stated that the board of directors appropriately serves an oversight role, supporting the proposal's investment adviser reporting requirements. The commenter

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314 Rule 12d1-4(b)(2)(i)(C).

315 *See supra* footnotes 271 through 276 and accompanying text.

316 *See, e.g.*, Dechert Comment Letter; NYC Bar Comment Letter; ABA Comment Letter.

317 *See* ABA Comment Letter (suggesting elimination of the best interest determination and board reporting requirements).

318 *See* NYC Bar Comment Letter.

recommended that the frequency of reporting should be set forth in a fund's policies and procedures adopted and approved by the board under rule 38a-1 under the Act.[319]

We continue to believe that the board of directors provides an additional layer of protection for acquiring and acquired funds that are management companies and their respective investors against the abuses historically associated with fund of funds arrangements. We are therefore adopting conditions that will require the investment adviser to each of the acquiring and acquired funds to report its evaluation, finding, and the basis for its evaluation or finding. We are adopting this change to the proposed rule to conform to the final rule's regulatory framework, which now applies to acquiring and acquired fund advisers. As proposed,[320] the final rule will not require a management company's adviser to make the applicable Fund Findings in connection with every investment in an acquired fund.

ii. UIT Findings

Rule 12d1-4 will include an alternative finding condition when the acquiring fund is a UIT. Specifically, 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.[321] The final rule will require the principal underwriter or depositor to base its finding on an evaluation of the complexity of the structure and the aggregate fees and expenses

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319 *See* MFDF Comment Letter.

320 *See* 2018 FOF Proposing Release, *supra* footnote 6, at n.143 and accompanying text.

321 Rule 12d1-4(b)(3)(ii).

associated with the UIT's investment in acquired funds.[322] This requirement is essentially the same as proposed.[323]

We received limited comments addressing this aspect of the proposal, but the comments received provided support or did not recommend any UIT-specific changes to the proposal.[324] For example, one commenter supported the rule requiring the principal underwriter or depositor of a UIT to make a finding regarding aggregate UIT and acquired fund fees.[325]

The condition for acquiring UITs under rule 12d1-4 differs from the condition applicable to acquiring management companies in many respects, and we believe that this is appropriate for several reasons. First, by statute, a UIT is unmanaged and its portfolio fixed.[326] Unlike a management company, a UIT does not have a board of directors, officers, or an investment adviser to render advice during the life of the trust. Second, acquiring UITs typically raise different fee and expense concerns than management companies. A UIT, for example, does not bear investment advisory fees, and the payments UITs make are limited by section 26 of the Act.[327]

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322 Under rule 12d1-4(b)(3)(iv), fund of funds arrangements (including acquiring and acquired funds that are UITs) must enter into a fund of funds investment agreement. *See infra* section II.C.2.4II.C.2.b.iv.

323 The only change is that we have revised the final rule to make clear that it requires the principal underwriter or depositor to consider expenses in addition to fees. *See supra* footnote 247.

324 *See* ABA Comment Letter; SIFMA AMG Comment Letter.

325 *See* ABA Comment Letter.

326 *See* 15 U.S.C. 80a-4(2) (defining a UIT, in part, to mean an investment company organized under a trust indenture or similar instrument that issues redeemable securities, each of which represents an undivided interest in a unit of specified securities).

327 Section 26(a)(2)(C) of the Act requires that the trust indenture for a UIT prohibit payments to the depositor or to any affiliated person thereof, except payments for performing bookkeeping and other administrative services of a character normally performed by the trustee or custodian itself. 80 U.S.C. 80a-26(a)(2)(C). UIT ETFs have exemptive relief that allow the ETF to pay certain enumerated expenses that would be prohibited under section 26(a)(2)(C). *See* Exchange-Traded Funds, Investment Company Act Release No. 33140 (July 31, 2018) [83 FR 37332 (July 31, 2018)] ("2018 ETF Proposing Release") at n.52 and accompanying text.

Due to the unmanaged nature of UITs and the fixed nature of their portfolios, we continue to believe it would be inconsistent with their structure to require a re-evaluation of their acquired fund finding over time or other reporting requirements. The requirement only applies, therefore, at the time of the UIT's creation. Nevertheless, this determination generally should consider the planned structure of the UIT's holdings. In particular, if the UIT tracks an index, the determination should consider the index design and whether the index design is likely to lead to the UIT holding acquired funds with duplicative fees or overly complex structures. We believe that the UIT-specific finding requirement that its fees and expenses do not duplicate the fees and expenses of the acquired funds that the UIT holds or will hold at the date of deposit, is an appropriately calibrated means to protect investors, given a UIT's unmanaged structure.

Unlike acquired management companies, we are not extending this finding requirement to acquired funds that are UITs.[328] We do not believe it is necessary to require these UITs to make similar findings given their structure. A UIT that is an acquired fund does not have similar section 12(d)(1) undue influence concerns as a management company because the UIT is unmanaged. This is distinguishable from UITs that are acquiring funds where we are only requiring UITs to consider the complexity of the structure and the aggregate fees and expenses associated with the UIT's investment, which is only relevant when the UIT is acquiring other funds.

This condition will apply only at the time of initial deposit for UITs that are formed after the rule's effective date as proposed. We do not believe it is necessary to exclude UITs that are already in existence from relying on rule 12d1-4 as acquiring funds. UITs that serve as separate

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[328] However, if the acquiring fund is a management company, it would need to make its own finding consistent with the rule. *See supra* footnote 248.

account vehicles funding variable annuity and variable life insurance contracts will be subject to additional fee conditions, as discussed below. The majority of UITs fall into this category.[329] In addition, we believe that existing UIT ETFs are unlikely to rely on rule 12d1-4 as acquiring funds because they replicate the components of broad-based securities indexes that do not currently include funds.[330] Even if funds were to become significant components of these indexes in the future, we believe that acquiring funds that invest in broad-based securities indexes are unlikely to raise complex structure concerns because the funds replicate the relevant index.[331] If an index were to include funds, the UIT ETF would simply acquire those funds as part of replicating the broader index. Such an arrangement also is unlikely to raise duplicative fee concerns because existing UIT ETFs do not bear advisory fees, sales loads, or other types of service fees at the UIT ETF level. Finally, UITs that do not serve as variable insurance contract separate account vehicles or that are not ETFs typically have a limited term, sometimes of approximately 12-18 months.[332] Given this short term, the number of UITs that have not made the finding required by rule 12d1-4 would decrease quickly over time. Absent this provision, it is unlikely that pre-existing UITs could rely upon the rule given the statutory requirement that

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329 According to UIT annual Form N-CEN filings, as of April 2020, insurance UITs made up 674 of the total 716 registered UITs.

330 There are five existing UIT ETFs that had total assets of approximately $436.6 billion as of December 31, 2019, representing 85.7% of UIT assets. All existing UIT ETFs seek to track the performance of a broad-based securities index by investing in the component securities of the index in the same approximate portions as the index.

331 The exemptive relief that has been granted to UIT ETFs provides that the trustee will make adjustments to the ETF's portfolio only pursuant to the specifications set forth in the trust formation documents in order to track changes in the ETF's underlying index. The trustee does not have discretion when making these portfolio adjustments. *See* 2018 ETF Proposing Release, *supra* footnote 81, at nn. 46-47 and accompanying text.

332 This estimate is based on staff sampling of equity UIT prospectuses.

UITs be organized under a trust indenture, contract of custodianship or agency, or similar instrument.

iii. Separate Accounts Funding Variable Insurance Contract Certification

With respect to a separate account funding variable insurance contracts that invests in an acquiring fund, the final rule will require 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 Act.[333] The standard set forth in section 26(f)(2)(A) of the Act 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. This requirement generally is the same as proposed.[334]

Comments received regarding the insurance company certification generally raised concerns with this requirement.[335] One commenter stated that the certification requirement is inappropriate because the separate account is a separate and distinct legal entity from the fund of funds arrangement.[336] For example, this commenter stated that typical fees associated with separate accounts, such as mortality and expense risk fees or account fees and expenses, are the responsibility of, and paid by, the insurance contract owners. Some commenters also stated that

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333 Rule 12d1-4(b)(2)(iii).

334 The only change is that we have revised the final rule to make clear that it requires the insurance company to consider expenses in addition to fees. *See supra* footnote 247.

335 *See, e.g.*, Nationwide Comment Letter; ICI Comment Letter; PGIM Comment Letter; ABA Comment Letter.

336 *See* Nationwide Comment Letter.

the acquiring fund's investment adviser may have limited ability to obtain or compel this type of certification from an unrelated insurance company to comply with the rule.[337]

Some commenters stated that section 26 of the Act already requires that the separate account and sponsoring insurance company fees and charges deducted under a variable insurance contract, in the aggregate, be reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurance company.[338] Commenters argued that, in making this determination, the insurance company sponsoring the separate account is entitled to rely on the obligations already imposed on the investment adviser and board of trustees of any fund in which the separate account invests, to ensure that the fees borne by any funds that are available through variable insurance contracts are appropriate.[339] Other commenters argued that the requirement was superfluous in light of existing requirements for review and approval of acquiring and acquired fund advisory agreements under section 15(c) of the Act and a fund adviser's fiduciary duty under section 36(b) of the Act with respect to the receipt of compensation for services, or of payments of a material nature, from an acquiring or acquired fund.[340]

We believe the final rule should include a condition that addresses the concerns underlying the limits in section 12(d)(1), particularly duplicative fee concerns, in this three-tier arrangement.[341] We disagree with commenters that the finding is unnecessary or duplicative of

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337 *See, e.g.*, Dechert Comment Letter; ICI Comment Letter; Comment Letter of Insured Retirement Institute (May 2, 2019) ("IRI Comment Letter").

338 *See* ICI Comment Letter; PGIM Comment Letter; ABA Comment Letter.

339 *See, e.g.*, Nationwide Comment Letter.

340 *See, e.g.*, PGIM Comment Letter; John Hancock Comment Letter; Dechert Comment Letter.

341 Rule 12d1-4 restricts fund of funds arrangements to two tiers other than in limited circumstances, such as master-feeder arrangements in reliance on section 12(d)(1)(E) of the Act. *See infra* section II.C.3 (discussing complex structure requirements).

section 15(c) or section 36(b) because we believe it is appropriate to address concerns with duplicative fees at each tier of the arrangement. In addition, section 15(c) and 36(b) generally will not apply in each tier of such an arrangement since the funds involved in this arrangement typically include UITs, which do not have boards of directors or investment advisers.[342] In addition, this certification requirement will ensure an analysis of the aggregate fee and expense structure of all the funds involved.

The final rule's conditions for separate accounts funding variable insurance contracts are based on the current fund of funds exemptive orders.[343] Our exemptive orders include a condition similar to the certification requirement.[344] Under the orders, the insurance company must certify to the acquiring fund that the aggregate of all fees and 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.

Under the rule, an insurance company sponsoring a separate account must 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 Act. Because the final rule will require most funds to enter into a fund of funds investment agreement, we considered whether to codify the approach of the exemptive orders and require that the fund of funds investment agreement include a representation regarding the insurance company's

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342 Section 15(c) of the Act applies to registered open-end funds that have a board of directors, whereas section 36(b) of the Act applies to certain payments to a registered investment company's investment adviser.

343 *See* 2018 FOF Proposing Release, *supra* footnote 6, at section II.C.3.c.

344 Specifically, in the orders, each acquiring fund must represent in its participation agreements with an acquired fund that no insurance company sponsoring a registered separate account funding variable insurance contracts will be permitted to invest in the acquiring fund unless the insurance company has made a certification to the acquiring fund. *Id.* at n.173-174 and accompanying text.

certification.[345] Rule 12d1-4 will not require that the fund of funds investment agreement include this representation, although the agreement may do so. This is consistent with our general approach not to codify in our rule all the particularized terms that an agreement must include to reflect the fund of funds arrangement.

iv. Fund of Funds Investment Agreements

The final rule will require funds to 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 rule 12d1-4 unless both funds have the same adviser.[346] This requirement works in tandem with the requirement to make certain Fund Findings by providing a method to hold the parties to the arrangement to the terms that led each fund's investment adviser to agree to the arrangement in the first place. In negotiating the fund of funds investment agreement, funds can set the terms of the agreement to support the Fund Findings. For example, 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. This agreement both sets the expectations of the parties at the outset of the arrangement and provides a method of enforceability should one party not live up to these expectations. Thus, the fund of funds investment agreement is designed to address historical abuse concerns under section 12(d)(1), including an acquiring fund threatening large-scale redemptions as a means of exercising undue influence over an acquired fund.[347] Further, the requirement to enter into such

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[345] The Commission proposed the certification requirement, in part, because the proposal did not contemplate participation agreements. *See* 2018 FOF Proposing Release, *supra* footnote 6, at section II.C.3.c.

[346] Rule 12d1-4(b)(2)(iv). Unlike the conditions relating to voting and control, the rule will require funds that are part of the same group of investment companies to enter into a fund of funds investment agreement if they do not have the same investment adviser.

[347] We believe that, due to the flexibility that the final rule provides in this regard, no special exceptions for certain funds or situations, such as interval funds or acquired fund liquidations, are necessary. *But see*

agreement puts the acquired fund on notice that an acquiring fund is investing in it in reliance on the rule.

In the 2018 Proposing Release, we requested comment on alternatives to the proposed redemption limit, specifically asking whether we should permit acquired funds to set their own redemption limit (and, if so, what parameters we should establish) or whether we should require participation agreements.[348] As discussed above, a number of commenters recommended a negotiated agreement similar to the participation agreements required in our exemptive orders as an alternative to the proposed redemption limit.[349] We agree with these commenters that a negotiated agreement, combined with the findings requirements discussed above, would be a more effective control against the threat of the use of large redemptions to exercise undue influence than the proposed redemption limit.

The fund of funds investment agreement differs in certain ways from the requirement in our exemptive orders that, prior to investing in another fund, acquiring and acquired funds enter into a participation agreement. Participation agreements under our orders require both funds in a fund of funds arrangement (and their investment advisers) to fulfill their responsibilities under the order.[350] Participation agreements also require that the acquiring fund notify the acquired

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NYC Bar Comment Letter (suggesting that these instances should be exempted from its proposed alternative approach to the proposed redemption limit). We would expect that the relevant parties would negotiate appropriate terms into their fund of funds investment agreement.

348 *See* 2018 FOF Proposing Release, *supra* footnote 6, at 57-58. We also requested comment on: (i) whether participation agreements require the parties to a fund of funds arrangement to provide information necessary for compliance with other provisions of the Act; and (ii) whether we should codify the conditions of existing exemptive orders including the procedural requirements. *See id*.

349 *See supra* footnotes 221 through 236, 266 through 270, and 296 through 299 and accompanying text.

350 Fund of funds exemptive orders require a participation agreement to state, without limitation, that the funds' boards and their investment advisers understand the terms and conditions of the order and agree to fulfill their responsibilities under the order. *See, e.g.*, ETF Managers Trust, et al., Investment Company Act Release Nos. 33799 (Feb. 19, 2020) [85 FR 10794 (Feb. 25, 2020)] (notice) and 33823 (Mar. 24, 2020) (order) and related application ("ETF Managers Trust").

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 Act.[351] Because all funds operating in accordance with rule 12d1-4 will be required to comply with the rule's conditions, the rule will not require that a fund of funds investment agreement include these types of contractual provisions.[352] 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 required finding. The agreement will empower funds relying on the rule to negotiate and tailor appropriate terms to protect their interests in a fund of funds arrangement. For example, the fund of funds investment agreement will provide a mechanism for an acquired fund to limit an acquiring fund's investments in reliance on the rule and arm itself with other tools it desires to protect against potential undue influence from an acquiring fund.

Rule 12d1-4 also will require funds operating in accordance with it to enter into a fund of funds investment agreement that includes three specific provisions. While some commenters suggested that we did not need to outline specific provisions in these agreements,[353] we believe that certain minimum requirements are necessary to ensure that the fund of funds agreement is effective at curtailing undue influence. These requirements are based on the Fund Findings, as

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351 While not required by exemptive orders, some funds include other provisions in participation agreements to govern the fund of funds arrangement, such as provisions related to mirror voting, waiver of compensation, and notification upon exceeding certain thresholds. We are not requiring that these conditions be included in the written agreement.

352 *See* ICI Comment Letter.

353 *See* ICI Comment Letter (stating that because a fund of funds arrangement would need to comply with the generally applicable provisions of the rule, its proposed alternative to a participation agreement would not require negotiation). *But see* Capital Group Comment Letter (suggesting that the Commission should include practical conditions in a participation agreement-type regime).

well as elements of our exemptive orders and commenters' recommendations in response to our requests for comment.[354]

First, the fund of funds investment agreement must include any material terms necessary for the adviser, underwriter, or depositor to make the Fund Finding where the funds involved include management companies or UITs.[355] This ensures that the adviser or other party making the Fund Finding will have memorialized the terms of the investment that underpin the Fund Finding, thereby making these terms fixed and clearly agreed if a dispute arises in the future. Given the importance of the Fund Findings to rule 12d1-4's protections, we believe that it is critical for the agreement to identify such terms to minimize ambiguity.

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.[356] This provision will give an acquired fund the ability to terminate an acquiring fund's acquisition of additional fund shares and provides the acquired fund with the negotiating leverage to address undue influence concerns. Termination of the agreement does not, unless otherwise agreed to by the parties, require that the acquiring fund reduce its position

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354 *See, e.g.,* ETF Managers Trust, *supra* footnote 350 (representing, among other things, that the participation agreement permitted an unaffiliated acquired fund to terminate it). *See also* ICI Comment Letter ("[r]equiring the acquired fund to agree to (and then terminate, if desired) the investment by an acquiring fund from a different group of investment companies would give the acquired fund a critical tool for protecting the interests of its shareholders"); Wells Fargo Comment Letter (stating that the standard representations, compliance polices, and other conditions accompanying participation agreements in the exemptive orders establish an effective framework of checks and balances that has successfully governed unaffiliated fund of funds arrangements); Fidelity Comment Letter (suggesting that in a participation agreement, an acquired fund could always protect itself by refusing to enter into such an agreement); NYC Bar Comment Letter (suggesting, among other things, that a participation agreement-type regime would permit the acquiring fund to negotiate the glide-path of redemptions).

355 Rule 12d1-4(b)(2)(iv)(A). This is not required of separate accounts because the acquiring fund is obtaining a certification from the insurance company offering the separate account rather than making a finding regarding the separate account.

356 Rule 12d1-4(b)(2)(iv)(B). The 60-day period is based upon a similar provision in section 15(a) of the Act. *See* 15 USC 80a-15(a)(3). We believe that this period is also consistent with the termination provision in some existing participation agreements.

in the acquired fund, but will prevent the acquiring fund from purchasing additional shares of the acquired fund beyond the limits of section 12(d)(1).[357]

Lastly, 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.[358] We believe that this requirement is appropriate to assist the acquiring fund's adviser with assessing the impact of fees and expenses associated with an investment in an acquired fund. For example, an acquired fund that invests in other funds would more readily have fee and expense information associated with the underlying investment than the acquiring fund, which may inform the acquiring fund's consideration of fees and expenses associated with an investment in the acquired fund. We believe that fund of funds investment agreements are material contracts not made in the ordinary course of business. As a result, they must be filed as an exhibit to each fund's registration statement.[359]

In sum, we believe that this requirement provides important additional protections beyond those provided by the Fund Findings requirement. First, it ensures both parties agree to the significant terms of the investment, including those terms on which the adviser or other party making the Fund Finding has based its analysis. Second, it ensures that an acquiring fund has the information it needs to assess the impact of the relevant fees and expenses. Lastly, these agreements permit funds to terminate the investment if they so choose, thereby ending the funds' ability to rely upon the rule for any additional investments in the acquired fund.

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357 Termination of the agreement would mean that the funds could no longer rely upon the rule to purchase or otherwise acquire, or sell or otherwise dispose of, fund securities in excess of the limits of section 12(d)(1) because they would not have a fund of funds investment agreement effective for the duration of the fund's reliance on the rule. *See* rule 12d1-4(b)(2)(iv).

358 Rule 12d1-4(b)(2)(iv)(C).

359 *See, e.g.,* Item 28(h) of Form N-1A.

The rule will not require acquired funds and acquiring funds that are advised by the same adviser to enter into a fund of funds investment agreement. We believe that there are comparatively fewer benefits to formalizing a fund of funds arrangement with an executed agreement if the funds have the same adviser, assuming that the funds' adviser has made the applicable Fund Finding. Given the importance of the fund of funds investment agreement to the structure of the rule, we think it is important to require it of every fund unless the same adviser is the primary adviser to both funds. That is, 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 in a fund of funds arrangement relying on the rule or as sub-adviser to both funds. We believe that this distinction is appropriate because a sub-adviser may not have the same access to information or be negotiating from the same position as other advisers. Thus, in situations where an adviser is the primary adviser to the acquired fund and serves as the sub-adviser to the acquiring fund, a fund of funds investment agreement would be required. Similarly, funds that do not have an adviser, such as internally managed funds or UITs, always would need to enter into a fund of funds investment agreement. Funds that do have the same adviser must still memorialize the arrangements that led the relevant adviser to make the Fund Finding for each fund under the rule.[360]

In the 2018 Proposing Release, we noted that an adviser to both an acquiring and acquired fund would owe a fiduciary duty to each of these funds.[361] As noted above, some commenters suggested that this was a reason to exclude affiliated funds of funds from the

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[360] Rule 12d1-4(c)(2). *See also supra* section II.C.4.

[361] 2018 FOF Proposing Release, *supra* footnote 6, at n.107 and accompanying text.

proposed redemption limit.[362] However, another commenter questioned whether advisers to more than one fund can effectively exercise their fiduciary duty to each fund independently of the other fund.[363] Advisers must act in accordance with their fiduciary duties to each respective fund, which should address the conflicts of interests advisers face when acting as an adviser to both the acquiring and acquired funds. Because of this, and the requirement to make the Fund Findings, we believe that it is unnecessary to apply the fund of funds investment agreement requirement to funds having the same adviser. In cases where 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.

We also are not exempting all funds within the same group of investment companies from the fund of funds investment agreement requirement, as suggested by a number of commenters in relation to the more-restrictive proposed redemption limit.[364] While some funds within the same group may have effective communication and controls such that a fund of funds investment agreement may seem duplicative, not all do. As we noted above, two funds in the same group of investment companies could have two different advisers and two different boards satisfying their fiduciary duties to their respective funds and shareholders. In some cases, the investment advisers to funds in the same group of investment companies are not even affiliated persons.[365] Further, these funds are likely subject to different compliance policies and

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362 *See* Wells Fargo Comment Letter; Thrivent Comment Letter; SIFMA AMG Comment Letter; *see also* John Hancock Comment Letter; MFS Comment Letter; Ropes Comment Letter.

363 *See* CFA Comment Letter.

364 *See supra* footnote 216 and accompanying text.

365 *See supra* footnotes 166 through 170 and accompanying text.

procedures and, as a result, we believe that a fund of funds investment agreement is an effective mechanism to memorialize the arrangement in these circumstances.

In summary, we believe that the requirement to enter into a fund of funds investment agreement, coupled with the expanded Fund Findings, are collectively a more effective approach than the proposed redemption limit to address undue influence concerns from redemptions. As compared to the proposed redemption limit that applied to all fund of funds arrangements, the conditions we are adopting provide funds with the ability to tailor their limits or protections to specific arrangements to better promote protection against potential undue influence and are more similar to requirements in orders providing section 12(d)(1) relief for fund of funds. As a result, we believe the rule, as adopted, will be an effective, less burdensome approach.

3. Complex Structures

A concern underlying section 12(d)(1) is that complex multi-tier fund structures could lead to excessive fees and investor confusion. To address this concern rule 12d1-4 will include conditions designed generally to restrict fund of funds arrangements to two-tiers, largely as proposed. Additionally, as proposed, rule 12d1-4 includes exceptions to the two-tier limitation that are limited in scope and designed to capture circumstances that do not raise the concerns underlying section 12(d)(1) of the Act. In response to concerns raised by commenters, however, we are adding an additional exception that will permit an acquired fund to invest up to 10% 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 (the "10% Bucket"). The final rule's conditions seek to permit innovation and efficient portfolio management while limiting the potential for confusing structures and duplicative fees.

a. General Prohibition on Three-Tier Structures

Rule 12d1-4 includes conditions designed to restrict fund of funds arrangements to two tiers (other than in limited circumstances), generally as proposed. Commenters were mixed with respect to the proposed rule's general prohibition on three-tier structures. Some commenters agreed with the Commission that multi-tier structures have the potential to confuse investors and generate duplicative fees.[366] One commenter, for example, supported a broad restriction that limits fund of funds arrangements to two levels.[367] Some commenters generally supported a prohibition on three-tier structures, but also advocated for broad-based exceptions for certain acquired fund investments in underlying funds that had been permitted under historical exemptive relief and included in the proposed rule.[368]

Other commenters stated that multi-tier structures may be beneficial and recommended that the Commission allow such structures by relying on other aspects of the rule to enhance investor protection.[369] Some commenters recommended that the rule permit certain specific multi-tier structures, stating that such structures are beneficial to fund shareholders and do not raise the concerns section 12(d)(1) was designed to prevent.[370] Similarly, one commenter wrote

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366 *See, e.g.*, CFA Comment Letter; Invesco Comment Letter; Voya Comment Letter.

367 CFA Comment Letter.

368 *See, e.g.,* Invesco Comment Letter (recommending exceptions for securities lending programs and cash sweep arrangements), Voya Comment Letter (recommending exceptions for master-feeder arrangements, short-term cash management, interfund borrowing and lending, and investments in wholly owned subsidiaries).

369 Morningstar Comment Letter (advising against a general prohibition on three-tier structures in favor of fee and expense disclosure in prospectuses and annual reports); TRP Comment Letter (stating that the proposed rule's requirements that an adviser evaluate the complexity of the structure and engage in a best interest finding are sufficient without a broader prohibition on three-tier structures).

370 *See, e.g.*, ICI Comment Letter (recommending that the rule include an expanded list of permitted multi-tier fund of fund arrangements that could be beneficial to shareholders); Fidelity Rutland Comment Letter (recommending that the rule permit the use of affiliated funds commonly created by an adviser for the purpose of efficiently managing exposure to a specific asset class (commonly referred to as "central funds")); Ropes Comment Letter (recommending that the rule permit three-tier structures where the underlying fund is an ETF or where all three funds in the structure are in the same group of investment companies); Comment Letter of Davis Polk & Wardwell LLP (May 2, 2019) ("DPW Comment Letter")

that the proposed three-tier condition was too rigid and would constrain legitimate three-tier arrangements.[371] Further, some commenters noted that the proposed condition would require restructuring of certain fund of funds arrangements, resulting in additional costs for investors and limiting the variety of investment strategies available in the marketplace.[372] Some commenters also recommended that the three tier limitations should not apply to acquired fund investments in private funds, since section 12(d)(1) does not restrict a fund from investing in private funds.[373]

As an alternative to the three-tier condition, some commenters suggested that the Commission require the acquiring fund adviser to engage in a best interest determination and enhanced board reporting on the use of complex structures.[374] Other commenters recommended that the Commission require enhanced investor disclosure rather than restricting fund structures.[375]

Although we acknowledge that three-tier structures may provide efficient and cost-effective exposure to certain market segments in certain circumstances, we continue to believe

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(recommending that the rule permit three-tier structures where the underlying fund is a limited life grantor trust).

371 TRP Comment Letter (recommending a principles-based approach that would generally permit multi-tier structures subject to the other conditions of the rule).

372 *See, e.g.*, PIMCO Comment Letter; Nuveen Comment Letter; SIFMA AMG Comment Letter.

373 ICI Comment Letter. *See also* IPA Comment Letter (recommending that the rule exempt BDC investments in private funds from the general prohibition on three-tier structures); Guggenheim Comment Letter (recommending an exception for structured finance vehicles if the rule generally prohibits acquired funds from investing in private funds).

374 TRP Comment Letter; SIFMA AMG Comment Letter.

375 *See, e.g.,* Morningstar Comment Letter; TRP Comment Letter (suggesting enhancing the proposed report to the board to include a statement that the adviser believes the fund of funds structure and disclosure documents sufficiently mitigate the risk of the three-tier structure being overly confusing to investors). *But See* CFA Comment Letter (expressing skepticism about the benefit of enhanced disclosures to retail investors) *citing* Study Regarding Financial Literacy Among Investors As Required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Staff of the U.S. Securities and Exchange Commission (August 2012).

that multi-tier structures can obfuscate the fund's investments, fees, and related risks.[376] For example, if an acquiring fund invests in an acquired fund that in turn invests in other funds, an acquiring fund shareholder could find it difficult to determine the nature and value of the holdings ultimately underlying his or her investment. Accordingly, we continue to believe that it is appropriate to limit the ability of funds to structure multi-tier arrangements in reliance on rule 12d1-4. We also believe that enhanced disclosure, without additional limitations on multi-tier structures, would be insufficient to address potential investor confusion associated with complex structures.[377] As discussed below, we have made certain modifications to the final rule, however, that are designed to provide additional flexibility for acquired funds to gain exposure to underlying funds in order to minimize disruption to existing fund structures and preserve some flexibility for efficient multi-tier arrangements.[378] We believe that the final rule's three-tier limitation appropriately provides such flexibility and provides protections against complex structures and excessive fees.

b. Limitations on Other Funds' Acquisitions of Acquiring Funds

Rule 12d1-4 includes a condition designed to prevent an acquiring fund from also being an acquired fund under the rule or under section 12(d)(1)(G) of the Act. Specifically, the rule prohibits a fund that is relying on section 12(d)(1)(G) of the Act (15 U.S.C. 80a-12(d)(1)(G)) 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 the second-tier fund makes

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376 *See* 2018 FOF Proposing Release, *supra* footnote 6, at 83.

377 *See infra* footnotes 388-390 and accompanying text.

378 *See, e.g.,* Guggenheim Comment Letter (predicting that many debt funds that serve as acquired funds would need to be restructured given that such funds hold substantial investments in entities that rely on section 3(c)(1) and 3(c)(7) of the act, such as structured finance vehicles).

investments permitted by rule 12d1-4(b)(3)(ii) as discussed below.[379] As a result, this condition will limit a fund's ability to create multi-tier arrangements, subject to certain limited exceptions. This condition is generally more comprehensive and, therefore, limiting, than the conditions in our orders, and addresses certain multi-tier arrangements that have emerged.[380]

This provision, however, will not prevent a fund from investing all of its assets in an acquiring fund in reliance on section 12(d)(1)(E).[381] We do not believe three-tier structures involving a master-feeder arrangement present the risk that section 12(d)(1) was designed to address. In addition, this condition will not prevent other funds from acquiring the voting securities of an acquiring fund in amounts of 3% or less, which effectively creates a type of three-tier structure that does not raise the concerns that section 12(d)(1) was designed to prevent.[382]

Rule 12d1-4's limitation on investments in acquiring funds is generally consistent with the proposed complex structures provision. However, the final rule will not apply the condition only to investments in an acquiring fund that discloses in its registration statement that it may be an acquiring fund for purposes of rule 12d1-4, as proposed.[383] Because rule 12d1-4 will require

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379 Rule 12d1-4(a)(3)(i). *See also* section 12(d)(1)(G)(v) (granting the Commission authority to prescribe rules or regulations with respect to acquisitions under section 12(d)(1)(G) as necessary and appropriate for the protection of investors).

380 *See* 2018 FOF Proposing Release, *supra* footnote 6, at 77 (noting that our orders do not expressly prohibit a fund from investing in an acquiring fund (*i.e.*, the top tier in a traditional fund of funds structure) beyond the limits in section 12(d)(1)).

381 For example, this type of three-tier structure would permit a target date fund (itself an acquiring fund) to simply act as a conduit through which an insurance product separate account invests.

382 A fund could acquire the securities of an acquiring fund within the limits of section 12(d)(1)(A). Funds relying on section 12(d)(1)(F) could acquire up to 3% of the outstanding voting securities in an unlimited number of funds. *See* section 12(d)(1)(F).

383 Proposed rule 12d1-4(b)(4)(ii) (prohibiting a fund relying on the rule or section 12(d)(1)(G) of the Act from acquiring the securities of a fund that discloses in its most recent registration statement that it may be an acquiring fund in reliance on proposed rule 12d1-4).

most funds to enter into a fund of funds investment agreement, and an adviser that manages both acquiring and acquired funds should have information regarding an acquired fund's investments, the final rule will prohibit a fund from investing in an acquiring fund without tying this limitation to registration statement disclosures.[384]

While several commenters addressed the proposed limit on multi-tier structures generally, no commenters addressed whether the rule should prohibit a fund from investing in an acquiring fund. We continue to believe that concerns of undue influence, complex structures, and excessive fees apply both to three-tier structures where registered funds invest in acquiring funds and three-tier structures where an acquired fund invests a substantial portion of its assets in other registered funds. Accordingly, we continue to believe that it is appropriate to limit funds' ability to invest in acquiring funds, subject to the exception for funds relying on section 12(d)(1)(E). We believe this condition will help limit the construction of complex multi-tier structures, while preserving some flexibility for efficient multi-tier arrangements. In addition, rule 12d1-4 does not prohibit other funds from acquiring the voting securities of an acquiring fund in amounts allowed by the Act (*i.e.*, 3% or less). We do not believe that multiple registered funds holding 3% or less of the acquiring fund implicate the historical abuses, such as undue influence, that section 12(d)(1) is intended to prevent.[385]

c. Limitations on Acquired Funds' Acquisition of Other Funds and Private Funds; Exceptions to Three-Tier Limitation

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384 We believe funds investing in reliance on section 12(d)(1)(G) likely would have, or be able to obtain, sufficient information to know which other funds within the same group of investment companies are acquiring funds under rule 12d1-4. *See* 2018 FOF Proposing Release, *supra* footnote 6, at 79. We do not believe that funds within the same group of investment companies will face challenges in obtaining this information because of the potential for information barriers. *See supra* section II.C.1.a.i.

385 *See* 2018 FOF Proposing Release, *supra* footnote 6, at 78-79.

As proposed, rule 12d1-4 will include a condition designed to limit fund of funds arrangements where the acquired fund is itself an acquiring fund. The rule generally will prohibit arrangements where an acquired fund invests in other investment companies or private funds in excess of the limits in section 12(d)(1)(A). Specifically, the 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 enumerated exceptions.[386] We continue to believe that the general limitation on acquired fund investments in other investment companies or private funds is an appropriate means to protect against the creation of overly complex structures.[387] While investments by acquired funds in other investment companies or in private funds may provide efficient exposure to a specific asset class or offer other portfolio management advantages, such investments can be confusing to investors and can result in additional fees and expenses.[388] We believe that this potential reduction of investment flexibility for acquired funds is appropriate to prevent potential increases in duplicative fees and expenses, and to avoid the investor confusion, that might occur if the final rule did not impose such limits

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386 Rule 12d1-4(b)(3)(ii). This prohibition applies to investments in a company that is controlled by an investment company, because such a controlled company is also subject to section 12(d)(1) when it acquires the securities of other investment companies. *See* section 12(d)(1)(A).

387 *See* 2018 FOF Proposing Release, *supra* footnote 6, at 81.

388 *See* Guggenheim Comment Letter. Although one commenter suggested that the rule should not limit an acquired fund's ability to invest in private funds because section 12(d)(1) of the Act does not limit a fund's ability to invest in private funds, (*See* ICI Comment Letter), the risks of investor confusion and fee layering apply both with respect to an acquired fund's investments in other investment companies and with respect to an acquired fund's investments in private funds in a multi-tier structure. Accordingly, we believe it is appropriate that the complex structures limitations of rule 12d1-4 apply to an acquired fund's investments in private funds. This approach also is consistent with the complex structures limitations in our exemptive orders.

on multi-tier structures.[389] As explained above with respect to complex structures generally, we believe a structural three-tier prohibition will help to limit the potential for complex structures that could be difficult for investors to understand even with comprehensive disclosures.[390]

Largely as proposed, the rule will allow arrangements where an acquired fund invests in other funds in certain enumerated circumstances. These exceptions are limited in scope and are designed to capture circumstances where an acquired fund may invest in another fund to efficiently manage uninvested cash, to address specific regulatory or tax limitations, or to facilitate certain transactions. Specifically, these categories include securities of another investment company that is: (i) acquired in reliance on section 12(d)(1)(E) of the Act (*i.e.*, master-feeder arrangements); (ii) acquired pursuant to rule 12d1-1; (iii) a subsidiary wholly-owned and controlled by the acquired fund; (iv) received as a dividend or as a result of a plan of reorganization of a company; or (v) acquired pursuant to exemptive relief from the Commission to engage in interfund borrowing and lending transactions.[391] These categories have been

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389 We believe it would be more appropriate for the Commission to consider multi-tier structures that do not fall within the confines of rule 12d1-4 through the exemptive application process. This will allow the Commission to weigh the policy considerations of such structures in the context of the facts and circumstances of the specific fund of funds arrangement described in the application. While the expenses of a third-tier fund may represent only a small proportion of the expenses of a top-tier acquiring fund because a third-tier fund would represent only a small proportion of the top tier acquiring fund's investment portfolio, the exemptive application process would permit the Commission to consider whether additional fee- or expense-related conditions would be appropriate in connection with a specific multi-tier arrangement or in connection with a specific investment strategy undertaken through a multi-tier structure.

390 For example, without a general three-tier prohibition, an acquired fund could shift a substantial portion of its assets among underlying funds with different investment exposures and risks, and disclosure at the acquiring fund level may still leave acquiring fund investors unaware of substantial changes to their investment exposure and risks at the acquired fund and underlying fund levels. *See* CFA Comment Letter (expressing skepticism about the benefit of enhanced disclosures to retail investors); *but see* Morningstar Comment Letter (supporting an enhanced disclosure requirement) and TRP Comment Letter (suggesting that the adviser report to the fund's board that a fund of funds disclosure documents sufficiently mitigate the risk of investor confusion).

391 Rule 12d1-4(b)(3)(ii).

permitted under existing exemptive orders and addressed in no-action letters, and do not raise the concerns that section 12(d)(1) was designed to address, as discussed further below.

We made several modifications to the enumerated exceptions of the proposed rule to address many of the concerns identified by commenters. Additionally, in a change from the proposal, rule 12d1-4 will include a separate exception that will permit an acquired fund to invest up to 10% of its assets in other investment companies or private funds. As discussed below, we do not believe that permitting these arrangements will raise concerns identified by Congress when enacting section 12(d)(1).[392]

i. Master-Feeder Investments

The proposed exception for master-feeder arrangements in reliance on section 12(d)(1)(E) of the Act did not receive substantial public comment and we are adopting as proposed.[393] Under section 12(d)(1)(E) of the Act, the acquired feeder fund in this example is, in effect, a conduit through which the acquiring fund can access the master fund. We do not believe that permitting these arrangements would create an overly complex structure that could confuse investors, nor do we believe that these arrangements involve concerns regarding undue influence or layering of fees.[394] For example, an acquired feeder fund's investment in its master fund would be entirely transparent because the feeder fund would disclose the master fund's portfolio holdings in its shareholder reports.

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392 *See also* 2018 FOF Proposing Release, *supra* footnote 6, pp 80-83 and associated footnotes (describing the enumerated circumstances under which our exemptive orders permitted three tier fund of funds structures and the rationale in support of such structures).

393 Voya Comment Letter (supporting the exceptions for master-feeder arrangements and investments in wholly-owned and controlled subsidiaries).

394 *See* 2018 FOF Proposing Release, *supra* footnote 6, at p. 78.

ii. Rule 12d1-1 Investments

The final rule will permit an acquired fund to invest more than 10% of its total assets in investment companies and private funds if such investments are made pursuant to rule 12d1-1. The proposed rule included an exception for short-term cash management purposes pursuant to rule 12d1-1 or exemptive relief from the Commission.[395]

Several commenters requested clarification or expansion of this proposed exception.[396] For instance, two commenters recommended that the Commission remove the phrase "short-term cash management purposes" from the exception because rule 12d1-1 does not include the phrase.[397] These commenters suggested there could be a variety of reasons other than short-term cash management that an acquired fund would invest in reliance on rule 12d1-1 that do not raise any additional fund of funds concerns.[398] Another commenter requested that the Commission clarify the applicable exemptive relief referenced in the exception, since the Commission also proposed to rescind relevant exemptive relief.[399]

Some commenters recommended that the final rule eliminate the reference to rule 12d1-1 and instead expand the types of investments that would be permitted for short-term cash management purposes to include short-term bond funds.[400] Another commenter recommended that the Commission expand the relief to permit acquired funds to equitize cash by investing in

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395 Proposed Rule 12d1-4(b)(3)(ii)(B).

396 *See, e.g.*, ICI Comment Letter; NYC Bar Comment Letter; PIMCO Comment Letter; PGIM Comment Letter.

397 NYC Bar Comment Letter; ICI Comment Letter.

398 ICI Comment Letter; Dechert Comment Letter (acquiring funds may make investments pursuant to rule 12d1-1 for the purpose of complying with asset coverage requirements and other legitimate portfolio management purposes).

399 ICI Comment Letter (noting it is unclear whether investments in short-term bond funds would be permitted under the proposed exception given the rescission of exemptive relief, despite numerous exemptive orders providing relief for investments in short-term bond funds).

400 ICI Comment Letter; PIMCO Comment Letter; PGIM Comment Letter.

other funds, such as certain ETFs.[401] One commenter recommended that the Commission also consider exceptions for securities lending and cash sweep arrangements among affiliates.[402]

In response to concerns raised by commenters, we have modified this exception to permit an acquired fund to invest in investment companies and private funds in excess of the section 12(d)(1) limits if such investments are made pursuant to rule 12d1-1.[403] By removing the phrase "short-term cash management purposes," the final rule will provide acquired funds with additional flexibility to invest in funds pursuant to rule 12d1-1 for any investment purpose. We also removed the reference to the phrase "or exemptive relief from the Commission" in order to clarify that the exception for acquired fund investments pursuant to rule 12d1-1 does not incorporate prior exemptive relief that an acquired fund may have received for cash management or collateral management purposes. As described below, we are rescinding this exemptive relief and removed the associated reference from the rule text. Although several commenters requested that the Commission not rescind prior exemptive relief that allows an acquired fund's investment in short-term bond funds for cash management or collateral management purposes, we believe rule 12d1-4 provides appropriate flexibility for funds to invest for these purposes. Specifically, rule 12d1-4 provides the 10% Bucket, which permits an acquired fund to invest up to 10% of its assets in other investment companies for any investment purposes.

In response to concerns raised by commenters relating to investments to equitize cash, the final rule will permit an acquired fund to invest up to 10% of its assets in other funds to equitize cash or for other investment purposes, pursuant to the 10% Bucket described in section

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401 ABA Comment Letter.

402 Invesco Comment Letter.

403 Rule 12d1-4(b)(3)(ii)(B).

II.C.3.d below.[404] The exception for investments pursuant to rule 12d1-1 is designed to permit acquired funds to invest in money market funds, which we do not believe raise the concerns that section 12(d)(1) was designed to prevent.[405] Accordingly, we decline to broaden the rule to permit additional investments under this exception, and clarify that investments are only permissible under this exception to the extent they are made pursuant to rule 12d1-1.

iii. Investments in a Wholly-Owned Subsidiary

We are adopting an exception from the three-tier limitation for investments in funds that are wholly-owned and controlled by the acquired fund, as proposed. Wholly-owned subsidiaries are typically organized under the laws of a non-U.S. jurisdiction in order to invest in commodity-related instruments and certain other instruments for tax and other reasons.[406] We requested comment as to whether the rule should include additional limits on acquired funds' use of subsidiaries, and requested suggestions on the contours of any such limitations.[407] Commenters did not address this aspect of the proposal, and rule 12d1-4 will include an exception to the general three-tier limitation for investments through such wholly-owned and controlled subsidiaries. Because the wholly-owned subsidiary's financial statements are consolidated with the financial statements of the acquired fund, we do not believe that this arrangement would be so complex that investors could not understand the nature of such exposure.[408]

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404 *See* ICI Comment Letter; PIMCO Comment Letter; PGIM Comment Letter; ABA Comment Letter.

405 *See* 2006 FOF Adopting Release, *supra* footnote 19, at 9-10.

406 *See* 2018 FOF Proposing Release, *supra* footnote 6, at pp. 82-83.

407 *See id*., at pp. 84.

408 In this type of arrangement, the acquired fund controls the wholly-owned subsidiary and the acquired fund consolidates its financial statements with the wholly-owned subsidiary's financial statements, provided that U.S. GAAP or other applicable accounting standards permit consolidation and acquired fund's total annual fund operating expenses include the wholly-owned subsidiaries' expenses. *See, e.g.*, Consulting Group Capital Markets Fund, et al., Investment Company Act Release Nos. 32940 (Dec. 15, 2017) [82 FR 60463 (Dec. 20, 2017)] (notice) and 32966 (Jan. 9, 2018) (order) and related application.

iv. Investments Received as a Dividend as a Result of a Plan of Reorganization and Investments Acquired to Engage in Interfund Borrowing and Lending

We continue to believe that it is appropriate to provide exceptions from the three-tier limitation to facilitate certain transactions.[409] The proposed rule included exceptions for arrangements where an acquired fund receives fund shares as a dividend or as a result of a plan of reorganization. Acquired funds do not acquire such investments to create a multi-tier fund structure. Rather, a fund acquires these investments from a business restructuring unrelated to a fund's status as an acquired fund under the rule.[410] The proposed rule also included an exception for acquired fund investments entered into pursuant to exemptive relief from the Commission to engage in interfund borrowing and lending transactions. This exception would facilitate certain interfund transactions, subject to conditions specifically designed to address the concerns that such transactions present under the terms of existing interfund lending orders.[411] A commenter supported the proposed rule's exception of these transactions from the three-tier limitation, and we continue to believe it is appropriate that the rule include these exceptions.[412] Therefore, we are adopting these exceptions as proposed.

d. Ten Percent Bucket

In addition to the enumerated exceptions to the limitation on acquired fund investments, the rule will permit an acquired fund to invest up to 10% of its total assets in other funds, regardless of the size of the investment in any one fund, in order to provide funds with additional

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409 *See* 2018 FOF Proposing Release, *supra* footnote 6, at 82.

410 *See* section 12(d)(1)(D) (exempting from section 12(d)(1) securities received as a dividend, as a result of an offer of exchange approved under section 11, or as a result of a plan of reorganization).

411 *See, e.g.*, Franklin Alternative Strategies Funds, *et al.*, Investment Company Act Release Nos. 33095 (May 10, 2018) [83 FR 22720 (May 16, 2018)] (notice) and 33117 (June 5, 2018) (order) and related application (permitting funds to participate in an interfund lending facility).

412 *See, e.g.,* Voya Comment Letter.

flexibility, and thereby permit certain structures that could benefit investors through greater efficiency. For purposes of calculating the 10% Bucket, investments by an acquired fund pursuant to the general exceptions in the section above would not be included. While the proposed rule did not include the 10% Bucket for acquired fund investments in other funds, we requested comment on whether the proposed rule's limitations were appropriately calibrated to mitigate complex structure concerns, and whether we should adopt different investment limits.[413] We also requested comment on whether the rule should permit acquired funds relying on section 12(d)(1)(G) to invest in a third-tier fund in order to centralize the portfolio management of floating rate or other instruments.[414]

Under rule 12d1-4, an acquired fund might utilize the 10% Bucket for cash management purposes outside of investments made in reliance on rule 12d1-1, to equitize cash, or for any other portfolio management purposes.[415] The 10% Bucket provides flexibility for fund of funds arrangements to evolve, while limiting the complex arrangements that section 12(d)(1) was designed to prevent. If an acquired fund wishes to acquire other underlying funds in excess of the 10% Bucket, the acquired fund may seek exemptive relief. In such circumstances, the Commission would have the opportunity to consider the proposed structure in the context of rule 12d1-4 and weigh the benefits of the proposed structure against the concerns underlying section 12(d)(1).

As discussed above, section 12(d)(1)(A)(iii) of the Act limits an acquiring fund's total investment in other funds to no more than 10% of the acquiring fund's assets. The 10% Bucket

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413 *See* 2018 FOF Proposing Release, *supra* footnote 6, at 84.

414 *See id*., at 86.

415 As an example, an acquired fund could utilize the 10% Bucket to invest in short-term bond funds for cash management purposes.

effectively applies this 10% limit to acquired funds' investments in underlying funds.[416] The rule as adopted, however, will not impose the 3% and the 5% limits of section 12(d)(1)(A)(i) and (ii), respectively, on investments by an acquired fund in third-tier funds. Accordingly, the rule will not prohibit an acquired fund from holding more than 3% of the outstanding voting securities of any single third-tier fund and will not prohibit an acquired fund from investing more than 5% of its assets in any single third-tier fund. Rather, the 10% Bucket will allow an acquired fund some flexibility to invest up to 10% of its assets in other funds in order to meet its investment objectives while minimizing shareholder confusion by limiting the extent of those acquired fund investments. This limit is intended to prohibit multiple layers of funds, which raise greater concerns of duplication of fees and expenses as well as investor confusion, and reflects a view that funds that invest in another fund beyond the 3% and the 5% limits of section 12(d)(1)(A)(i) and (ii), but not the 10% limit of section 12(d)(1)(A)(iii), are not primarily designed to invest in other funds and do not implicate the concerns that led to the adoption of the 10% limit in 1970.[417] In such a structure, by which an acquired fund relies on the 10% Bucket to

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416 Like the limits under section 12(d)(1) of the Act, the 10% Bucket is an acquisition test. Accordingly, if an acquired fund holds more than 10% of its assets in other underlying funds due to market movements it could not invest any additional assets in underlying funds, but the 10% Bucket would not require the acquired fund to dispose of its existing investments in underlying funds to under 10% of its assets. Further, if an existing acquired fund holds more than 10% of its total assets in other 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 the rule. However, the acquired fund could invest additional assets in underlying funds only in accordance with the terms of the rule.

417 *See* Reporting Modernization Adopting Release, *supra* footnote 56, at 81936. *See also* PPI Report *supra* footnote 64, at page 322 (describing concerns about the organization and operation of registered fund holding companies whose primary purpose is the acquisition of shares of other registered investment companies). The House and Senate Reports that accompanied the 1970 amendments to the Act describe concerns about "fundholding companies" whose portfolios consist entirely or largely of the securities of other investment companies. *See* H.R. Rep. No. 1382, 91st Cong., 2d Sess. 28 (1970) ("1970 Amendments House Report"); S. Rep. No. 184, 91st Cong., 1st Sess. 29 (1969) ("1970 Amendments Senate Report"). By imposing the 10% limit in section 12(d)(1)(A)(iii) as part of the 1970 amendments to the Act, Congress distinguished between investment companies that invest less than 10% of their assets in other investment companies, on the one hand, and fund holding companies whose primary purpose is the acquisition of shares of other registered investment companies, on the other.

invest in an underlying fund in excess of the section 12(d)(1) limits, the acquired fund and underlying funds must comply with the conditions of rule 12d1-4 as acquiring and acquired funds, respectively, or operate pursuant to another exemption.[418]

We proposed a similar provision in 2008 as part of a proposal to allow funds to invest in ETFs beyond the section 12(d)(1) statutory limits.[419] In order to prevent the formation of overly complex structures, the proposed 2008 rule would have prohibited an acquired ETF from investing more than 10% of its assets in other funds and private funds. One commenter on proposed rule 12d1-4 recommended that rule 12d1-4 include a 10% bucket to provide additional flexibility for acquired fund investments in other funds, and noted that the Commission's 2008 rule proposal included such a provision.[420]

As discussed in the 2018 FOF Proposing Release, our staff has previously stated that it would not recommend enforcement action if an acquired fund in a fund of funds arrangement invested up to 10% of its assets in other funds, including "central funds," which are affiliated funds commonly created by an adviser for the purpose of efficiently managing exposure to a specific asset class.[421] However, the staff stated its position in light of several considerations,

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418 For example, if an acquired fund invests 10% of its total assets in a third-tier underlying fund, and the investment by the acquired fund accounts for 20% of the voting stock of the underlying fund, the acquired fund and the underlying fund would be required to comply with the conditions of rule 12d1-4 as an acquiring fund and acquired fund, respectively.

419 2008 ETF Proposing Release, *supra* footnote 18, at n.225 and accompanying text (requiring an acquired ETF to have a disclosed policy that prohibits it from investing more than 10% of its assets in other investment companies in reliance on section 12(d)(1)(F) and 12(d)(1)(G) of the Act).

420 ICI Comment Letter ("Allowing for this exception generally would permit the structures contemplated by the recent no-action letters and the 2008 Commission proposal, and permit acquired funds to have additional limited ability to invest in other funds when such investments would not exceed the basic 10 percent limit included in Section 12(d)(1)(A)(iii) to protect against overly complex structures.").

421 2018 FOF Proposing Release, *supra* footnote 6, at 86. *See* Franklin Templeton Investments, Staff No-Action Letter (pub. avail. April 3, 2015) ("Franklin Templeton No-Action Letter"). In the Franklin Templeton No-Action Letter, the staff stated it would not recommend that the Commission take any enforcement action under sections 12(d)(1)(A) and (B) (and other sections of the Act) if an acquiring fund relying on section 12(d)(1)(G) purchases or otherwise acquires shares of an underlying fund that, in turn,

including that: (a) an acquired fund would not exceed the 5% limit in section 12(d)(1)(A)(ii) with respect to an investment in shares of a single central fund or the 10% limit in 12(d)(1)(A)(iii) with respect to investments in underlying investment companies generally; (b) management fees and other fees that were subject to limits; (c) acquisitions by the central fund in other investment companies or private funds that were subject to limits; (d) a requirement that shares of the central fund be sold solely to the funds within the same group of investment companies; and (e) the board of directors of each of the funds would consider the reasons for the proposed investments in the central fund and the benefits expected to be realized from such investments.[422] In a subsequent letter, the staff stated that it would not recommend enforcement action if an acquired fund invested, solely for short-term cash management purposes, up to 25% of its assets in a central fund that is a fixed-income fund that could have a dollar-weighted average portfolio maturity of up to 3 years.[423]

Several commenters advocated that the final rule permit acquired funds to invest in central funds.[424] Commenters noted that central funds are frequently used for cash management

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purchases or otherwise acquires shares of a central fund. The Franklin Templeton No-Action Letter also included a representation that an acquired fund's adviser would waive fees on assets invested in underlying central funds.

422 Franklin Templeton No-Action Letter.

423 Thrivent Financial for Lutherans and Thrivent Asset Management LLC, Staff No-Action Letter (pub. avail. Sep. 27, 2016) ("Thrivent No-Action Letter"). The circumstances of the Thrivent No-Action Letter did not involve a limitation on acquired funds exceeding the 5% limit in section 12(d)(1)(A)(ii) with respect to an investment in shares of a single central fund, and included a representation that the central funds would not charge advisory fees). *See id*. Rule 12d1-4(b)(3)(ii)(B) provides cash management flexibility by permitting an acquired fund to invest in other investment companies or private funds beyond the 10% limit if the acquired fund makes such investments in reliance on rule 12d1-1.

424 Comment Letter of MFS Investment Management (May 2, 2019); Fidelity Comment Letter; PGIM Comment Letter (cash management); ICI Comment Letter (short-term bond funds); Thrivent Comment Letter (25% of its total assets in one or more short-term bond funds); Guggenheim Comment Letter (short-term bond funds); Dechert Comment Letter (short-term bond funds); NYC Bar Comment Letter (money market funds); Fidelity Rutland Trust Comment Letter; SIFMA AMG Comment Letter; Comment Letter of Capital Research and Management Company (Jan. 8, 2019) ("Capital Group (2) Comment Letter").

purposes, but could also be used to gain exposure to any asset class or sector.[425] Several commenters recommended that the rule permit acquired funds to invest in private funds, structured finance vehicles, and other entities that rely on sections 3(c)(1) or 3(c)(7) of the Act that are not traditionally considered pooled investment vehicles.[426] Other commenters requested an exception for acquired fund investments in ETFs.[427] While the final rule does not incorporate prior staff positions regarding acquired fund investments in central funds, the rule provides substantial flexibility for fund groups to continue to utilize central funds within the 10% Bucket. The 10% Bucket allows acquired funds to gain exposure to any asset class or sector through investments in affiliated or unaffiliated underlying investment companies and private funds without imposing many of the limitations that were associated with prior staff positions in this area.

As we discussed in the 2018 FOF Proposing Release, some existing multi-tier structures may be required to modify their investments to ensure compliance with rule 12d1-4.[428] For example, as of June 2018, we identified 231 three-tier structures for which both the first- and second-tier funds invested in other funds beyond the limits in section 12(d)(1).[429] Such multi-tier arrangements may need to restructure their holdings over time to continue to maintain the same investment, to the extent that the acquired funds in such structures invest more than 10% of their

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425 *See, e.g.,* Capital Group (2) Comment Letter (describing central fund investments in investment-grade corporate bonds, mortgage-backed securities and high yield securities).

426 ICI Comment Letter; Guggenheim Comment Letter; Dechert Comment Letter; Comment Letter of Small Business Investor Alliance, et al.(Feb. 28. 2019) ("SBIA Comment Letter"); FS Comment Letter; IPA Comment Letter; PIMCO Comment Letter; SIFMA AMG Comment Letter.

427 Ropes Comment Letter; Chapman Comment Letter; ICI Comment Letter.

428 2018 FOF Proposing Release, *supra* footnote 6, at 150.

429 *Id.*

assets in underlying funds, exclusive of investments in underlying funds made pursuant to the enumerated exceptions described above.[430]

We agree with commenters that additional flexibility to enter into multi-tier arrangements could lead to efficiencies and cost savings for fund investors. However, unlimited ability to enter into multi-tier arrangements could lead to complex structures in which an acquiring fund shareholder finds it difficult to determine the nature and value of the holdings ultimately underlying his or her investment. We do not believe that a 25% limit would be appropriate for investments in underlying funds in pursuit of any investment purpose because such a limit is based on considerations related to investments in central funds for short-term cash management purposes. In addition, such a limit would be far in excess of the 10% limit that Congress enacted in 1970 in response to its concerns about "fund holding" companies.[431] Accordingly, rule 12d1-4 provides flexibility for acquired funds to invest in private funds, structured finance vehicles, central funds, ETFs, and other investment funds up to a 10% limit, consistent with the 10% limit set forth in section 12(d)(1). We believe that this 10% Bucket, when combined with the enumerated exceptions discussed above, will provide flexibility for beneficial multi-tier arrangements while limiting the harms that Congress sought to prevent.

4. Recordkeeping

The final rule will require the acquiring and acquired funds that participate in fund of funds arrangements in accordance with the rule to maintain and preserve certain written records

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430 As noted above, because the 10% Bucket is an acquisition test, if an acquired fund holds more than 10% of its assets in other 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 the rule. However, the acquired fund could invest additional assets in underlying funds only in accordance with the terms of the rule.

431 *See* 1970 Amendments House Report; 1970 Amendments Senate Report *supra* footnote 417 and accompanying text.

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; (ii) a written record of the relevant Fund Finding made under the rule and the basis therefor within the past five years; and (iii) the certification from each insurance company required by the rule.[432] These requirements are largely as proposed, with the addition of fund of funds investment agreement records as these agreements were not part of the proposal. Also, to match the expansion of the Fund Findings requirement, both acquiring and acquired funds will need to keep records of the applicable evaluations and findings under the final rule. We also are not adopting the proposed requirement to keep the reports provided to the board of directors regarding management company findings, as we believe that this would be duplicative with the requirements of rule 31a-1, particularly the requirements to keep minute books of directors' meetings and advisory material received from the investment adviser.[433] We did not receive comments on the recordkeeping provisions of the proposed rule.[434]

Funds and UITs currently have compliance program-related recordkeeping procedures in place that incorporate this type of retention period, and consistency with that period minimizes compliance burdens to funds related to the preservation of the records.[435] Although the retention period would differ from the required period for UIT findings under rule 22e-4 and the general recordkeeping requirements in rule 31a-2, we believe it is appropriate to have consistent

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[432] Rule 12d1-4(c).

[433] Rule 31a-1(b)(4) and (11).

[434] We received comments on the substantive elements underlying the proposed recordkeeping requirements. *See supra* section II.C.2.b (discussing proposed findings and determinations requirements and related comments).

[435] The retention period is consistent with the period provided in rule 38a-1(d).

recordkeeping requirements under rule 12d1-4.[436] We believe that these recordkeeping requirements allow for external examinations of compliance with this condition without placing an undue burden on the funds. Moreover, because the fund of funds investment agreement sets forth the relevant material terms of the fund of funds arrangement specific to particular acquiring funds and acquired funds, we believe it is appropriate to include it as part of a fund's recordkeeping requirements.

D. Rescission of Rule 12d1-2 and Amendment to Rule 12d1-1

1. Rescission of Rule 12d1-2

We are rescinding rule 12d1-2, as proposed, to create a more consistent and efficient regulatory framework for the regulation of fund of funds arrangements. As discussed above, 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." A fund relying on this exemption is subject to certain conditions, including a condition limiting the types of securities an acquiring fund can hold, in addition to the shares of funds in the same group of investment companies, to government securities and short-term paper.[437] Congress designed this limit to restrict the use of this exemption to a "bona fide" fund of funds, while providing the fund with a source of liquidity to redeem shares.[438]

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436 *See* rule 22e-4(c) (requiring a UIT to maintain, for the life of the UIT and for five years thereafter, a record of the determination that the portion of the illiquid investments that the UIT holds or will hold at the date of deposit that are assets is consistent with the redeemable nature of the securities it issues). *See also* Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32315 (Oct. 13, 2016) [81 FR 82142 (Nov. 18, 2016)]; 2018 FOF Proposing Release, *supra* footnote 6, at 69.

437 *See* 15 U.S.C. 80a-12(d)(1)(G)(i)(II). The acquired fund also must have a policy against investing in shares of other funds in reliance on section 12(d)(1)(F) or 12(d)(1)(G) to prevent multi-tier structures, and overall distribution expenses are limited to prevent excessive sales loads.

438 *See* Fund of Funds Investments, Investment Company Act Release No. 26198 (Oct. 1, 2003) [68 FR 58226 (Oct. 8, 2003)].

In 2006, the Commission exercised its exemptive authority to adopt rule 12d1-2.[439] Rule 12d1-2 codified, and in some cases expanded, three types of relief that the Commission provided for fund of funds arrangements that did not conform to the section 12(d)(1)(G) limits. Specifically, rule 12d1-2 permitted a fund 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);[440] (ii) invest directly in stocks, bonds, and other securities;[441] and (iii) acquire the securities of money market funds in reliance on rule 12d1-1.[442] Rule 12d1-2 was designed to provide a fund relying on section 12(d)(1)(G) with greater flexibility to meet its investment objective when the risks that lead to the restrictions in section 12(d)(1) are minimized.[443] The Commission stated that the investments permitted under rule 12d1-2 did not raise additional concerns under section 12(d)(1)(G) because: (i) they were not investments in funds; or (ii) they represented fund investments that are limited in scope (*i.e.*, cash sweep arrangements under rule 12d1-1) or amount (*i.e.*, up to the limit in section 12(d)(1)(A) or 12(d)(1)(F)).[444]

We have also granted exemptions that permit funds to invest in funds within the same group of investment companies as an alternative to the requirements of section 12(d)(1)(G) and

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439 *See* 2006 FOF Adopting Release, *supra* footnote 19.

440 *See* rule 12d1-2(a)(1).

441 *See* rule 12d1-2(a)(2). Rule 12d1-2 limits investments to "securities." The Commission has issued a series of exemptive orders that allow a fund relying on section 12(d)(1)(G) to invest in financial instruments that may not be "securities." These orders provide that the funds will comply with rule 12d1-2, but for the ability to invest in a portion of their assets in these other investments. *See, e.g.*, Van Eck Associates Corp, *et al*., Investment Company Act Release Nos. 31547 (Apr. 6, 2015) [80 FR 19380 (Apr. 10, 2015)] (notice) and 31596 (May 6, 2015) (order) and related application.

442 17 CFR 270.12d1-2(a)(3).

443 2006 FOF Adopting Release, *supra* footnote 19.

444 *Id.*

rule 12d1-2.[445] Funds relying on these orders could invest in the same group of related investment companies and unaffiliated funds without regard to the limitations in sections 12(d)(1)(A) or 12(d)(1)(F). In addition, funds relying on our exemptive orders could invest to a greater extent in funds that were not part of the same group of investment companies and in other investments. Funds relying on exemptive relief also could invest in closed-end funds to a greater extent than funds relying on section 12(d)(1)(G) combined with rule 12d1-2 and could invest in other financial instruments that may not be securities within the meaning of section 2(a)(36) of the Act, such as derivatives.[446]

Our exemptive orders include conditions that differ from the conditions in section 12(d)(1)(G) and the conditions within those orders also differ depending on whether the investment involves an acquired fund that is in the same group of investment companies.[447] The orders generally subject investments in funds that are not part of the same group of investment companies to a broader set of conditions designed to protect investors from the harms Congress sought to address by enacting section 12(d)(1).[448] Under this existing framework, substantially

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445 *See* Janus Investment Fund, *et al.*, Investment Company Act Release Nos. 31753 (Aug. 13, 2015) (notice) and 31808 (Sept. 9, 2015) (order) and related application ("Janus Investment Fund").

446 A fund relying on section 12(d)(1)(G) and rule 12d1-2 could acquire no more than 3% of a closed-end fund's outstanding voting securities. A fund relying on an exemptive order could acquire an unlimited amount of the voting securities of a closed-end fund in the same group of investment companies and up to 25% of the outstanding voting securities of other closed-end funds. Further, funds are limited to investments in securities if they rely upon section 12(d)(1)(G) and rule 12d1-2. *See supra* footnote 441.

447 *See, e.g.,* Northern Lights Fund Trust, *et al.*, Investment Company Act Release Nos. 32973 (Jan. 23, 2018) [83 FR 4081 (Jan. 29, 2018)] (notice) and 33008 (Feb. 21, 2018) (order) and related application (setting forth conditions applicable to affiliated fund of funds arrangements, including that: (1) any sales charges or service fees charged with respect to shares of acquiring funds would not exceed the limits set forth in FINRA Rule 2341; and (2) no acquired fund will acquire securities of any other investment company in excess of the limitations of section 12(d)(1) except to the extent that such acquired fund (a) acquires such securities in compliance with section 12(d)(1)(E), (b) receives such securities as a dividend or as the result of a plan of reorganization, or (c) acquires such securities pursuant to exemptive relief from the Commission permitting the acquired fund to acquire the securities of investment companies for short-term cash management purposes or to engage in interfund lending).

448 *See supra* footnote 446 and accompanying text (regarding conditions applicable to unaffiliated acquired funds).

similar fund of funds arrangements are subject to different limitations and conditions.[449] This has resulted in an inconsistent and inefficient regulatory framework where the relief on which a fund of funds arrangement is relying is not always clear to other funds, investors, or regulators.

Commenters generally opposed the proposed rescission of rule 12d1-2.[450] Some commenters stated that rescinding rule 12d1-2 would disrupt investment strategies, opportunities, and operations, and lead to an increase in funds' compliance or investing costs.[451] Commenters also suggested, as discussed in more detail below, that the rescission of rule 12d1-2, along with the rescission of exemptive orders and withdrawal of staff letters, would impact funds' ability to utilize certain fund structures, such as three-tier central fund arrangements.[452] Several commenters suggested a number of changes to proposed rule 12d1-4 in response to the Commission's proposed rescission of rule 12d1-2.[453] For example, these commenters recommended eliminating or substantially restructuring the proposed redemption limit, exempting funds within the same group of investment companies from the proposed redemption limit, or permitting continued reliance on rule 12d1-2 for funds in the same group of investment companies.[454] In particular, two of these commenters raised specific concerns about the

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449 *See supra* footnote 26.

450 *See, e.g.*, Allianz Comment Letter; Invesco Comment Letter; Thrivent Comment Letter, PIMCO Comment Letter; Fidelity Rutland Comment Letter; Schwab Comment Letter; NYC Bar Comment Letter; PGIM Comment Letter, BlackRock Comment Letter; ABA Comment Letter; SIFMA AMG Comment Letter; Capital Group Comment Letter.

451 *See, e.g.*, Allianz Comment Letter; Thrivent Comment Letter; PIMCO Comment Letter; ABA Comment Letter; SIFMA AMG Comment Letter.

452 *See generally* PIMCO Comment Letter.

453 *See, e.g.*, Allianz Comment Letter; Thrivent Comment Letter; NYC Bar Comment Letter; ABA Comment Letter; BlackRock Comment Letter; PIMCO Comment Letter; Fidelity Rutland Comment Letter; PGIM Comment Letter; SIFMA AMG Comment Letter.

454 *See, e.g.*, NYC Bar Comment Letter; PIMCO Comment Letter; SIFMA AMG Comment Letter.

proposed redemption limit's impact on fund of funds arrangements if the Commission rescinds rule 12d1-2.

Some commenters recommended that the Commission retain rule 12d1-2 and codify existing exemptive orders permitting funds relying on rule 12d1-2 to enter into derivatives and financial instruments.[455] As an alternative, some commenters suggested that the Commission "grandfather" existing fund of funds arrangements that rely on rule 12d1-2 if the Commission rescinds the rule.[456] Commenters stated that rescinding rule 12d1-2 would increase costs and operational inefficiencies by requiring existing fund of funds arrangements to either: (i) comply with section 12(d)(1)(G) of the Act and eliminate any investments other than those permitted under the statute; or (ii) operate in accordance with rule 12d1-4 and restructure to comply with the proposed redemption limit and complex structure limitations.[457]

We continue to believe that it is necessary to rescind rule 12d1-2 in order to harmonize the overall regulatory structure and create a consistent and efficient regulatory framework for the regulation of fund of funds investments. The rescission of rule 12d1-2 will eliminate some of 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.[458] Accordingly, funds that wish to invest in funds within the same group of investment companies

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455 *See, e.g.*, PIMCO Comment Letter; Fidelity Rutland Comment Letter; PGIM Comment Letter; BlackRock Comment Letter; ABA Comment Letter; SIFMA AMG Comment Letter.

456 *See, e.g.*, Allianz Comment Letter; Thrivent Comment Letter.

457 *See, e.g.*, PIMCO Comment Letter; ABA Comment Letter; NYC Bar Comment Letter; SIFMA AMG Comment Letter.

458 Rule 12d1-2(a)(1) and (a)(2). In connection with our proposed amendment to rule 12d1-1 discussed below, funds relying on section 12(d)(1)(G) could continue to invest in money market funds that are not part of the same group of investment companies even with the proposed rescission of rule 12d1-2(a)(3).

beyond the limits in section 12(d)(1)(A), as well as other securities and the securities of the other funds, will no longer be able to rely on section 12(d)(1)(G) and rule 12d1-2.[459] Instead, acquiring funds will have flexibility to invest in different types of funds and other asset classes under rule 12d1-4 under a single set of conditions that are tailored to address the concerns that underlie section 12(d)(1) of the Act.

We believe that this approach will enhance investor protection by subjecting more funds of funds arrangements to the conditions in rule 12d1-4. As we discussed in the 2018 FOF Proposing Release, the purpose of this rule is to streamline and enhance the regulatory framework applicable to fund of funds arrangements. As we have exercised our statutory authority to exempt fund of funds arrangements, we have created a regulatory regime where substantially similar fund of funds arrangements are subject to different conditions. The rule reflects decades of experience with fund of funds arrangements, and will subject funds that operate in accordance with it to a tailored set of conditions that we believe will help protect investors from the harms Congress sought to address by enacting section 12(d)(1) of the Act. The requirements of the rule are designed to provide investors with the benefits of fund of funds arrangements while protecting them from the historical abuses that section 12(d)(1) is designed to prevent.[460] We therefore believe that it is crucial that fund of funds arrangements follow the protections of rule 12d1-4 and are rescinding rule 12d1-2. We also are not exempting or providing other relief for existing investments for these funds for similar reasons.

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[459] Funds also may continue to rely on section 12(d)(1)(F) to make smaller investments in a number of funds and section 12(d)(1)(E) to invest all of their assets in a master-feeder arrangement. *See supra* footnote 20 and accompanying text.

[460] *See* 2018 FOF Proposing Release, *supra* footnote 6.

We believe that the tailored conditions in rule 12d1-4 are appropriate to protect investors and create a harmonized fund of funds regulatory regime. We further believe that for fund of funds arrangements currently relying on rule 12d1-2, reliance on rule 12d1-4 will be less disruptive to their arrangements than suggested by commenters because the final rule does not include a redemption limit and permits an acquired fund to invest up to 10% of its total assets in other funds.[461] Additionally, rule 12d1-4 includes tailored conditions for fund of funds arrangements in the same group of investment companies by excepting them from the rule's control and voting conditions.

As proposed, in order to limit the hardship that the rescission of rule 12d1-2 could have on existing fund of funds arrangements, we are adopting a one-year period after the effective date before rule 12d1-2 is rescinded. We did not receive comment on this aspect of the proposed rescission of rule 12d1-2. We believe that one year is adequate time for funds relying on current rule 12d1-2 to bring their future operations into conformity with section 12(d)(1)(G) or rule 12d1-4. We also decline to exempt existing funds relying on rule 12d1-2 past this one-year period, as suggested by some commenters,[462] because it would add unnecessary complexity to the regulatory framework and potentially create an uneven playing field for funds based on differing rule conditions, as discussed above.

2. Amendment to Rule 12d1-1

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461 *See* NYC Bar Comment Letter (suggesting that eliminating the proposed redemption limit would address commenters' inflexibility concerns with the proposed rescission of rule 12d1-2); *see also* SIFMA AMG Comment Letter (suggesting that the Commission should exempt affiliated fund of funds arrangements from the proposed redemption limit). *See supra* section II.C.3 (discussing complex structures including general exceptions to the three-tier limitation and the 10% Bucket provision). *See infra* section V.C.1.a (discussing Form N-PORT data related to the proposed redemption limit).

462 *See supra* footnote 456 and accompanying text.

We are adopting an amendment to rule 12d1-1 under the Act, as proposed, to allow funds relying on section 12(d)(1)(G) to also rely upon the rule. This provides these funds with continued flexibility to invest in money market funds outside of the same group of investment companies despite the rescission of rule 12d1-2.[463] Comments received on this aspect of the proposal supported it.[464]

We continue to believe that such investments in money market funds do not raise the concerns that underlie section 12(d)(1).[465] We also believe that retaining this flexibility will help funds in smaller complexes that do not have a money market fund as part of their fund complex invest in an unaffiliated money market fund, subject to the conditions of rule 12d1-1.[466] This limited flexibility may be less costly than complying with section 12(d)(1)(G)'s limited conditions.[467] We are therefore amending rule 12d1-1 as proposed, to provide an exemption from section 12(d)(1)(G) for an investment company to acquire the securities of a money market fund.

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463 Rule 12d1-1(a) provides an exemption from section 12(d)(1)(G) for an investment company to acquire the securities of a money market fund. Rule 12d1-2, which we propose to rescind, provided the same relief.

464 *See, e.g.*, BlackRock Comment Letter.

465 *See* 2006 FOF Adopting Release, *supra* footnote 19, at n.23 and accompanying text.

466 *See id*., at section II.A.1(a).

467 *See, e.g.*, section 12(d)(1)(G)(i)(III)(bb) (limiting combined sales charges and service fees to limits under current FINRA sales rule); section 12(d)(1)(G)(i)(IV) (requiring the acquired fund to have a policy that prohibits it from acquiring securities of registered open-end investment companies or registered UITs in reliance on section 12(d)(1)(G) or (F)).

E. Disclosures Relating to Fund of Funds Arrangements

1. Amendments to Form N-CEN

Form N-CEN is a structured form that requires registered funds to provide census-type information to the Commission on an annual basis.[468] Form N-CEN provides both the Commission and the public with enhanced and updated census-type information on a wide-range of compliance, risk assessment, and policy related matters.[469] We proposed to add a requirement to Form N-CEN that would require reporting if a management company relied on rule 12d1-4 or the statutory exception in section 12(d)(1)(G) during the reporting period. While Form N-CEN already requires a management company to report if it is a fund of funds, we proposed to collect this information in order to better assess reliance on rule 12d1-4 or the statutory exception in section 12(d)(1)(G) by management companies and to assist us with our accounting, auditing and oversight functions. We also proposed to require UITs to report if they relied on proposed rule 12d1-4 or the statutory exception in section 12(d)(1)(G) during the reporting period. In proposing this requirement, we noted that the UIT section of Form N-CEN does not currently require a UIT to identify if it is a fund of funds.[470]

Commenters that addressed the proposed amendments to Form N-CEN supported them,[471] and we are adopting these amendments to the form as proposed.[472] We believe the amendments we are adopting to the form will help us better assess reliance on rule 12d1-4, or the statutory exception in section 12(d)(1)(G). In turn, this will allow the staff to evaluate whether

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468 *See, e.g.,* Reporting Modernization Adopting Release, *supra* footnote 56.

469 *Id.*

470 2018 FOF Proposing Release, *supra* footnote 6.

471 *See, e.g.*, Federated Comment Letter; Voya Comment Letter; ICI Comment Letter.

472 Items C.7.l. and C.7.m. of Form N-CEN (for management companies) and Items F.18 and F.19 of Form N-CEN (for UITs).

additional disclosure is needed. These amendments to Form N-CEN will also assist with our accounting, auditing and oversight functions, including compliance with the Paperwork Reduction Act.[473]

2. Acquired Fund Fees and Expenses

An acquiring fund is currently required to disclose the fees and expenses it incurs indirectly from investing in shares of one or more acquired funds. In Form N-1A, for example, an open-end fund investing in another fund is required to include in its prospectus fee table an additional line item titled "Acquired Fund Fees and Expenses".[474] Since we adopted the AFFE disclosure requirement, some have expressed concerns about the impact of this disclosure on certain acquired funds, including BDCs.[475] The 2018 FOF Proposing Release requested comment on fees and expenses, including with respect to AFFE disclosure.

Some commenters similarly expressed certain concerns about current AFFE disclosure requirements. For example, several commenters suggested that fee table disclosure should focus

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473 We are also making conforming changes to the title of Item C.7. of Form N-CEN to reflect that the item includes a statutory exemption. *See* amendment to Item C.7. ("Reliance on certain statutory exemption and rules. Did the Fund rely on the following statutory exemption or any of the rules under the Act during the reporting period? (check all that apply)").

474 *See* Instruction 3(f)(i) to Item 3 of Form N-1A. Other forms, including N-2, N-3, N-4 and N-6 similarly require disclosure relating to AFFE. *See, e.g.,* Instruction 10.a to Item 3.1 of Form N-2. A fund may include AFFE in the line item for "Other Expenses" rather than in a separate line item if the aggregate expenses attributable to acquired funds does not exceed 0.01%

475 *See, e.g.,* ICI Comment Letter to File No. S7-12-18, https://www.sec.gov/comments/s7-12-18/s71218-4560073-176206.pdf; House Report to [Omnibus Spending Bill/H.R. 3280] (July 17, 2017), https://www.congress.gov/congressional-report/115th-congress/house-report/234/1?overview=closed; Fidelity Management & Research Company, Petition for Rulemaking (Dec. 28, 2006), https://www.sec.gov/rules/petitions/2006/petn4-528.pdf ("Fidelity Petition"); *see also* Comment Letter of the Coalition for Business Development to File No. 812-15065, https://www.sec.gov/comments/s7-27-18/s72718-6668087-203950.pdf (Jan. 16, 2020); Comment Letter of Brett Palmer, President, SBIA, et al. to File No. S7-27-18, https://www.sec.gov/comments/s7-27-18/s72718-6892436-211002.pdf (Feb. 28. 2020) ("SBIA Comment Letter 2"); Comment Letter of Gwen Moore, Steve Stivers, Brad Sherman and Bill Huizenga, Members of Congress to File No. S7-27-18, https://www.sec.gov/comments/s7-27-18/s72718-6913308-211215.pdf (March 5, 2020).

on a fund's operating expenses and should not incorporate AFFE.[476] Some commenters suggested eliminating the inclusion of certain investment-related expenses in fee tables in the prospectus for all types of funds, or moving AFFE disclosure to the risk factors or narrative description of a prospectus.[477] Several commenters also expressed particular concern about treating BDCs as acquired fund investments and recommended excluding BDC investments from AFFE.[478]

On the other hand, some commenters expressed general support for the current AFFE disclosure requirements in the prospectus fee table.[479] Two commenters credited AFFE disclosure for providing investors with the necessary information to understand the potential layering of fees in fund of funds arrangements and to compare similar funds and expenses.[480]

We are not addressing AFFE disclosure requirements as part of this rulemaking. Instead, we are considering modifications to AFFE disclosure as part of a broader review of how funds disclose fees in their prospectuses.[481] In this regard, in the Investor Experience Proposal, the

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476 *See, e.g.,* ICI Comment Letter; PIMCO Comment Letter; Invesco Comment Letter; Chapman Comment Letter; SIFMA AMG Comment Letter.

477 *See, e.g.,* PIMCO Comment Letter; Invesco Comment Letter; SIFMA AMG Comment Letter.

478 *See, e.g.*, SBIA Comment Letter (stating that AFFE disclosure distorts an acquiring fund's expense ratio and has disproportionately harmed BDCs because this disclosure requirement has led to funds no longer investing in BDCs and several index providers dropping BDCs from their indexes); Chapman Comment Letter; Nuveen Comment Letter; FS Comment Letter; Chamber of Commerce Comment Letter; Comment Letter of Alternative Credit Council (May 2, 2019) (stating that AFFE disclosure overstates the costs of a fund investing in a BDC because it essentially requires double-counting of a BDC's operating expenses and that because AFFE disclosure has effectively resulted in funds no longer investing in BDCs, it has restricted the market for BDCs, limited institutional ownership of BDCs, and reduced investor choice); ICI Comment Letter; John Hancock Comment Letter.

479 Kauff Comment Letter at 2; Rand Comment Letter at 1-2; Cooper Comment Letter at 1-2.

480 Kauff Comment Letter; Rand Comment Letter.

481 *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, Investment Company Act Release No. 33963 (Aug. 5, 2020) ("Investor Experience Proposal"). The Commission, in proposing the AFFE disclosure modifications in the Investor Experience Proposal, considered comments received in connection with the 2018 FOF Proposing

Commission requested comment on a proposal to replace the current requirement that AFFE be included in the prospectus fee table of open-end funds regardless of the scope of investments in acquired funds with a more tailored requirement based on the percentage of assets invested in acquired funds.[482] This amendment, which the Commission proposed in conjunction with other changes to funds' prospectus fee disclosure requirements, would permit open-end funds that invest 10% or less of their total assets in acquired funds to omit AFFE from the fund's bottom line expenses in the fee table and instead disclose the amount of the fund's AFFE in a footnote to the fee table. Open-end funds that invest more than 10% of their total assets in acquired funds would continue to present AFFE as a line item in the prospectus fee table, as they do today. The Commission also requested comment on whether to amend AFFE disclosure requirements similarly for other types of registered investment companies.

F. Compliance Dates

The Commission is providing for a transition period for the amendments to Form N-CEN. Specifically, we are adopting compliance dates for our amendment to Form N-CEN of January 19, 2022, one year following the amendment's effective date. All reports on this form filed on or after the compliance date must comply with the amendments. Based on the staff's experience, we believe that this will provide adequate time for affected funds to compile and review the information that must be disclosed.

III. Rescission of Exemptive Relief; Withdrawal of Staff Letters

Pursuant to our authority under the Act to amend or rescind our orders when necessary or appropriate to the exercise of the powers conferred elsewhere in the Act, we are rescinding, as

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Release. *Id.*, at paragraph accompanying n. 608. The comment period for the Investor Experience Proposal closes 60 days after its publication in the Federal Register.

482 *Id.* at paragraph accompanying n. 615.

proposed, the exemptive relief permitting fund of funds arrangements that fall within the scope of rule 12d1-4.[483] As discussed in more detail below, exemptive relief granted to fund of funds arrangements outside the scope of the rule is not being rescinded.

We proposed to rescind all orders granting relief from sections 12(d)(1)(A), (B), (C), and (G) of the Act with one limited exception. We did not propose to rescind the exemptive orders providing relief from section 12(d)(1)(A) and (B) granted to allow certain interfund lending arrangements.[484] Interfund lending arrangements allow certain funds within the same complex to lend money to and borrow money from each other for temporary purposes and subject to certain conditions. While such arrangements require exemptive relief from sections 12(d)(1)(A) and (B), among other provisions, we stated that they do not result in the pyramiding of funds or the related potential abuses that the proposed rule was designed to address, and thus they were not included within the scope of the proposed rule.

We also proposed to rescind the exemptive relief from sections 12(d)(1)(A) and (B) that has been included in our ETF and ETMF orders.[485] We believed that rescinding this fund of funds relief in the ETF and ETMF orders, as well as more generally, would establish a transparent regulatory framework for these arrangements. As discussed in the 2018 FOF Proposing Release, we expected that the need to comply with the requirements of proposed rule

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483 *See* section 38(a) of the Investment Company Act (15 U.S.C. 80a–37(a)).

484 *See* 2018 FOF Proposing Release, *supra* footnote 6, at 95.

485 Some of the exemptive orders we have issued to ETFs include relief permitting ETFs to use certain master-feeder arrangements. We rescinded other master-feeder fund relief generally, while continuing to permit ETF master-feeder arrangements to rely on that relief as part of the implementation of rule 6c-11. *See* 2019 ETF Adopting Release, *supra* footnote 25. In addition, we understand that existing ETMFs currently rely on the master-feeder relief in the orders and did not propose to rescind that relief. *See, e.g.*, Eaton Vance Management, et al., Investment Company Act Release Nos. 31333 (Nov. 6, 2014) (notice) and 31361 (Dec. 2, 2014) (order) ("Eaton Vance Order").

12d1-4, as opposed to their orders, would not significantly negatively affect the operations of most existing fund of funds arrangements.[486]

Commenters had mixed reactions to our proposal to rescind existing fund of funds exemptive orders. Several commenters supported the proposed rescission of exemptive orders in connection with the adoption of rule 12d1-4, citing the benefits of a standardized rule.[487] Many other commenters requested that we not rescind existing fund of funds exemptive orders, and instead codify and expand on existing prior exemptive orders.[488] These commenters stated that our proposal would eliminate a fund's ability to rely on existing fund of funds relief and could result in undue costs and burdens, including potential restructuring of existing arrangements.

Other commenters suggested the Commission take a tailored approach in order to limit disruption to existing fund of funds arrangements.[489] For example, one commenter requested we rescind only the exemptive orders described in the 2018 FOF Proposing Release.[490] Many commenters requested additional specificity as to which exemptive orders would be withdrawn, and whether the Commission intended to withdraw relief from provisions of the Act other than section 12(d)(1) in such exemptive orders.[491]

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486 2018 FOF Proposing Release, *supra* footnote 6, at 96. *See also* section II.D.

487 *See, e.g.,* MFDF Comment Letter; Morningstar Comment Letter; TRP Comment Letter.

488 *See, e.g.,* Nationwide Comment Letter; ICI Comment Letter; Federated 2 Comment Letter; Allianz Comment Letter; Fidelity Fixed Income Trustees Comment Letter; Fidelity Comment Letter.

489 John Hancock Comment Letter; Federated Comment Letter; TRP Comment Letter.

490 NYC Bar Comment Letter.

491 *See, e.g.,* Nationwide Comment Letter; ICI Comment Letter; Voya Comment Letter; TRP Comment Letter; Federated Comment Letter; NYC Bar Comment Letter; Federated Comment Letter; Dechert Comment Letter; Chamber of Commerce Comment Letter.

As discussed in more detail below, several commenters requested that the Commission expand the rule to incorporate individualized relief set forth in certain exemptive orders.[492] Alternatively, some commenters suggested that the Commission preserve existing orders, and allow current recipients of exemptive relief to follow the conditions of their relief rather than relying on the rule.[493] One commenter suggested that the Commission give the holders of exemptive orders at least a one-year period to transition operations or obtain new exemptive relief.[494]

As proposed, and as discussed in more detail below, we are rescinding the fund of funds exemptive orders that fall within the scope of rule 12d1-4. Specifically, we are rescinding exemptive relief that permits investments in funds beyond the limits in 12(d)(1)(A), (B), or (C) of the Act, other than in circumstances that we believe are outside the scope of rule 12d1-4 as discussed below. We are also rescinding exemptive relief under section 12(d)(1)(G) that permits an affiliated fund of funds to invest in assets that are beyond the scope of that statutory provision. We continue to believe that rescinding these orders will help to create a consistent framework for fund of funds arrangements, subject to conditions that appropriately address the concerns underlying section 12(d)(1), including the prevention of overly complex structures for funds of funds. In order to limit the hardship that revocation of these orders could have on existing fund of funds arrangements, however, we are adopting a one-year period after the effective date

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492 Nationwide Comment Letter; Allianz Comment Letter; DPW Comment Letter; Voya Comment Letter; Capital Group Comment Letter; Fidelity Comment; NYC Bar Comment Letter; PIMCO Comment Letter; PGIM Comment Letter; Federated 2 Comment Letter.

493 *See, e.g.*, Allianz Comment Letter; PGIM Comment Letter; ABA Comment Letter; Fidelity Fixed Income Trustees Comment Letter; Fidelity Rutland Comment Letter; John Hancock Comment Letter.

494 NYC Bar Comment Letter.

before rescission to give acquiring and acquired funds relying on these exemptive orders time to conform their operations with the requirements of the rule and rule amendments.

Fund of funds exemptive relief that falls outside the scope of rule 12d1-4, as well as the relevant portions of fund of funds exemptive orders that grant relief for provisions in the Act outside of the scope of this rulemaking, will remain in place. For example, we have issued several exemptive orders that provide relief from sections 17(a) and 17(d) of the Act and rule 17d-1 under the Act that allow a registered fund to invest in private funds.[495] We are not rescinding the relief from section 17(a) and under section 17(d) and rule 17d-1 granted in these orders. Similarly, we are not rescinding the portions of certain funds of funds exemptive orders that grant relief from section 17(d) of the Act and rule 17d-1 under the Act to enter into fee sharing agreements to avoid duplicative fees.[496] In addition, to the extent we rescind 12(d)(1) relief, we are also rescinding any related 17(a) relief for the acquisition and redemption of fund shares by another fund. We are not, however, rescinding 17(a) relief permitting sales or redemptions of fund shares in-kind or portfolio transactions between two funds.

The major topical areas of fund of funds exemptive relief that are within the scope of rule 12d1-4 are as follows:

> *Standard Fund of Funds Relief*. Our exemptive relief relating to standard fund of funds arrangements generally grants exemptions from sections 12(d)(1)(A), (B), and (C) of the Act and sections 17(a)(1) and (2) of the Act to permit acquiring

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495 *See, e.g.,* Aberdeen Asset Management Inc., et al., Investment Company Act Release Nos. 33058 (March 27, 2018) (notice) and 33080 (April 24, 2018) (order).

496 *See, e.g.,* Lord Abbett Investment Trust, et al., Investment Company Act Release Nos. 23088 (March 27, 1998) (notice) and 23122 (April 21, 1998) (order) (granting relief for, among other things, a servicing arrangement under which one or more of the applicant funds may pay a portion of the administrative expenses of another applicant fund).

funds to invest in acquired funds in excess of the limits of in section 12(d)(1) of the Act.[497] This relief is rescinded, one year from the effective date of the rule.

Fund of Funds Relief for ETFs and ETMFs. As proposed, the exemptive relief from sections 12(d)(1)(A) and (B) that has been included in our ETF and ETMF orders is rescinded, one year from the effective date of the rule.

ETFs Relying on Rule 6c-11. In 2019, we adopted rule 6c-11 under the Investment Company Act to permit ETFs that satisfy certain conditions to operate without the expense and delay of obtaining an exemptive order from the Commission under the Act.[498] In connection with that rulemaking, we rescinded those portions of certain ETF exemptive orders that grant relief related to the formation and operation of an ETF, but we did not rescind the relief provided to ETFs from section 12(d)(1) and sections 17(a)(1) and (a)(2) under the Act related to fund of funds arrangements involving ETFs. The fund of funds exemptive relief for these ETFs is rescinded as well.[499]

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497 The standard fund of funds orders grant an exemption from sections 12(d)(1)(A) and 12(d)(1)(B). *See, e.g.* Aberdeen Asset Management Inc., et al., Investment Company Act Release Nos. 28429 (Sept. 30, 2008) (notice) and 28475 (Oct. 28, 2008) (order). A subcategory of these standard fund of funds exemptive orders also grant additional relief under section 12(d)(1)(C) to permit investment in closed-end funds beyond the limits imposed by section 12(d)(1)(C). *See, e.g.,* Ares Credit and Income Trust and Ares Capital Management III LLC, Investment Company Act Release Nos. 33243 (Sept. 21, 2018) (notice) and 33275 (Oct. 17, 2018) (order). The rescission of standard fund of funds exemptive orders applies to the orders that grant additional relief under section 12(d)(1)(C), as well, since that relief is within the scope of rule 12d1-4.

498 2019 ETF Adopting Release, *supra* footnote 25, at 8.

499 *Id.* We also stated that ETFs relying on rule 6c-11 that do not have exemptive relief from sections 12(d)(1)(A) and (B) may enter into fund of funds arrangements as set forth in recent ETF exemptive orders, provided that such ETFs satisfy the terms and conditions for fund of funds relief in those orders. The 2019 ETF Adopting Release noted that this position would be available only until the effective date of a rule permitting registered funds to acquire the securities of other registered funds in excess of the limits in section 12(d)(1), including rule 12d1-4 if adopted. *See id*. at 130-133 In order to give any ETFs relying on this position sufficient time to come into compliance with rule 12d1-4, however, this position will be available for a one-year period following the effective date of rule 12d1-4.

Fund of Funds Relief for Non-Transparent ETFs and ETMFs. We also have granted exemptive relief permitting certain actively managed ETFs to operate without being subject to the daily portfolio transparency condition included in other actively managed ETF orders ("non-transparent ETFs").[500] These orders include relief from sections 12(d)(1)(A) and (B) of the Act to permit certain fund of funds arrangements. We also have granted relief from sections 12(d)(1)(A) and (B) permitting ETMFs to be an acquired fund in a fund of funds arrangement.[501] We believe that non-transparent ETFs and ETMFs raise the same concerns regarding the pyramiding of funds and the related potential abuses that the rule is designed to address. As a result, relief under section 12(d)(1)(A) and (B) for non-transparent ETFs and ETMFs is rescinded as proposed.[502]

Fund of Funds Direct Investment Relief. We have granted exemptive relief to permit fund of funds arrangements that rely on section 12(d)(1)(G) of the Act to invest in assets other than funds within the same group of investment companies, government securities, and short-term paper. Certain exemptive relief granted prior to the adoption of rule 12d1-2 in 2006 permitted funds of funds relying on section 12(d)(1)(G) to invest in securities and other financial instruments.[503] Some exemptive orders granted after the adoption of rule 12d1-2 provide relief from rule 12d1-2(a) to the extent necessary to permit an acquiring fund that relies

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500 Because these non-transparent ETFs do not provide daily portfolio transparency, they do not meet the conditions of rule 6c-11. *See* 2019 ETF Adopting Release, *supra* footnote 25, at text accompanying n. 192.

501 *See, e.g.*, Eaton Vance Order, *supra* footnote 485.

502 *See supra* footnote 485 noting that master-feeder relief for ETMFs will not be rescinded.

503 *See, e.g.,* Nations Fund Trust, Investment Company Act Release Nos. 24781 (Dec. 1, 2000) (notice) and 24804 (Dec. 27, 2000) (order) (permitting a fund to invest in funds in the same group of investment companies and in other securities (not issued by another fund)).

on section 12(d)(1)(G) of the Act to invest in financial instruments that may not be "securities."[504] Although some commenters requested we retain the relief for direct investments,[505] we are rescinding this relief, one year from the effective date of the rule. As discussed above in section II.D, we are rescinding rule 12d1-2 in order to create a more consistent and efficient regulatory framework for the regulation of fund of funds arrangements. We similarly believe that rescinding the direct investment exemptive relief will establish an appropriate, consistent framework for the regulation of these fund of funds arrangements by subjecting them to the conditions of rule 12d1-4 if they continue to invest in assets other than those permitted by section 12(d)(1)(G) of the Act.

Fund of Funds Affiliated Structures. The Commission granted certain exemptive relief to permit an open-end fund or UIT to invest in other open-end funds and UITs that are in the "same group of investment companies" in excess of the limits in section 12(d)(1), subject to certain enumerated conditions.[506] Some exemptive orders also permitted funds of funds to invest in an affiliated closed-end fund.[507]

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504 *See, e.g.,* Context Capital Advisors, LLC, et al., Investment Company Act Release Nos. 31689 (June 24, 2015) and 31720 (July 21, 2015). As discussed in more detail below, certain staff no-action letters in connection with this rulemaking, including Northern Lights Fund Trust, SEC Staff No-Action Letter (June 29, 2015) ("Northern Lights Letter") will be withdrawn. The Northern Lights Letter permits an affiliated fund of funds arrangement relying on section 12(d)(1)(G) and rule 12d1-2 to invest a portion of its assets in other financial instruments (*e.g.*, derivatives that are not securities under the Act), consistent with its investment objectives, policies and restrictions.

505 *See, e.g.,* Allianz Comment Letter.

506 Some of these orders pre-date the implementation of section 12(d)(1)(G), while other orders also included this relief for certain affiliated fund of funds arrangements after the implementation of section 12(d)(1)(G). *See, e.g.,* Franklin Templeton Fund Manager, *et al.*, Investment Company Act Release Nos. 21964 (May 20, 1996) (notice) and 22022 (June 17, 1996) (order); Aberdeen Asset Management Inc., *et al.*, Investment Company Act Release Nos. 28429 (Sept. 30, 2008) (notice) and 28475 (Oct. 28, 2008) (order). *See also supra* section II.B for a general discussion of exemptive relief related to affiliated structures.

507 *See, e.g.*, Sierra Asset Management Portfolios, et al., Investment Company Act Release Nos. 22842 (Oct. 7, 1997) (notice) and 22869 (Oct. 31, 1997) (order).

As with the standard fund of funds relief, we are rescinding the affiliated structure relief. These fund of funds arrangements may rely on section 12(d)(1)(G) or rule 12d1-4 to the extent they intend to purchase other funds in the same group of funds beyond the limits of section 12(d)(1). Additionally, although several commenters requested that the Commission not rescind certain exemptive relief that allows an acquired fund's investment in short-term bond funds for cash management or collateral management purposes,[508] rule 12d1-4 provides appropriate flexibility for funds to invest for these purposes. Specifically, rule 12d1-4 permits an acquiring fund to invest in any acquired fund in excess of the statutory limits pursuant to the conditions of the rule. Further, rule 12d1-4 provides an exception from the rule's general prohibition against three tiers to permit an acquired fund to invest in an underlying fund pursuant to rule 12d1-1 in excess of the statutory limits, and provides the 10% Bucket, which permits an acquired fund to invest up to 10% of its assets in other investment companies for any investment purposes. Rule 12d1-4 limits the potential for confusing structures and duplicative fees, while providing the flexibility of the 10% Bucket. Accordingly, we believe it is appropriate to rescind this relief, one year from the effective date of the rule. For similar reasons, we believe it is appropriate to rescind the exemptive relief that acquired funds have relied on to invest in "central funds."[509] We believe that the 10% Bucket provided in rule 12d1-4,

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508 *See* PGIM Comment Letter (referring to its exemptive order permitting acquired funds (and acquiring funds) to invest in a public or private short-term bond fund for cash management purposes).

509 *See supra* footnote 421 and accompanying text describing central funds. *See also* PIMCO Comment Letter (referring to PIMCO Funds, et al., Investment Company Act Release Nos. 25220 (Oct. 22, 2001) (notice) and 25272 (Nov. 19, 2001) (order)). *See also supra* footnote 424 for commenters addressing central fund

when combined with the enumerated exceptions discussed above, will provide appropriate flexibility for beneficial multi-tier arrangements while limiting the harms that Congress sought to prevent. Accordingly, the central funds exemptive relief falls within the scope of rule 12d1-4 and is rescinded, one year from the effective date of the rule.[510] As discussed above, some existing multi-tier structures, including "central funds" arrangements that currently rely on existing exemptive relief, may be required to modify their investments to ensure compliance with rule 12d1-4.[511] However, unlimited ability to enter into multi-tier arrangements could lead to complex structures in which an acquiring fund shareholder finds it difficult to determine the nature and value of the holdings ultimately underlying his or her investment.

Captive Funds. One commenter requested that the Commission retain exemptive orders for fund of funds arrangements that are captive to an affiliated managed account program.[512] This commenter stated these kinds of captive funds of funds are simply conduits that advisers use to deliver a more efficient range of investment strategies and achieve a more consistent allocation of investment

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arrangements, including related to the Thrivent No-Action Letter.

510 As discussed in more detail below, certain staff no-action letters in connection with this rulemaking, including Franklin Templeton Investments, SEC Staff No-Action Letter (Apr. 3, 2015) ("FTI Letter") will be withdrawn. The FTI Letter permits underlying funds to rely on 12(d)(1)(G) to invest in a central fund that invests in floating rate securities.

511 *See* section II.C.3.d, noting that as of June 2018, we identified 231 three-tier structures for which both the first- and second-tier funds invested in other funds beyond the limits in section 12(d)(1) that may need to restructure their holdings over time to continue to maintain the same investment, to the extent that the acquired funds in such structures invest more than 10% of their assets in underlying funds, exclusive of investments in underlying funds that are made pursuant to the enumerated exceptions described above; *see also* 2018 FOF Proposing Release, *supra* footnote 6, at 150.

512 Fidelity Comment Letter (referring to Fidelity Rutland Square Trust, et al., Investment Company Act Release Nos. 28259 (Apr. 30, 2008) (notice) and 28287 (May 28, 2008) (order)).

strategies across these accounts. We recognize that rescinding such exemptive relief may cause fund of funds arrangements that are captive to an affiliated managed account program to restructure to comply with the conditions of rule 12d1-4.[513] However, rule 12d1-4 provides appropriate flexibility and conditions for affiliated fund of funds structures, including structures that are captive to an affiliated managed account program. Accordingly, such exemptive relief is rescinded, one year from the effective date of the rule.

We have also given relief from section 12(d)(1) in certain circumstances that we believe are outside the scope of rule 12d1-4. The major topical areas section 12(d)(1) exemptive relief that we believe are outside the scope of rule 12d1-4 are as follows:

Interfund Lending. As proposed, we are not rescinding the exemptive relief from section 12(d)(1)(A) and (B) granted to allow certain interfund lending arrangements. Commenters generally agreed with this approach.[514] We continue to believe that these arrangements do not result in the pyramiding of funds or the related potential abuses that rule 12d1-4 is designed to address.

Affiliated Insurance Fund Relief. Commenters requested more clarity with respect to certain orders allowing insurance funds to invest in fixed income instruments issued by affiliates. For example, one commenter requested clarification regarding the status of its 2002 exemptive relief, which permits its funds of funds to invest in affiliated and unaffiliated underlying funds, other

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513 *See* section V.C.1.ii for an analysis of the anticipated benefits and costs of rescinding exemptive orders; *see also* section V.D.1 for the economic analysis of retaining existing exemptive orders.

514 *See, e.g.*, Voya Comment Letter.

securities, and a fixed interest contract issued by its affiliate.[515] Another commenter similarly requested clarification whether we are rescinding its exemptive relief, a portion of which allows funds to invest in a guaranteed rate investment contract issued by an affiliate.[516] The orders cited by these commenters grant exemptions from 12(d)(1)(A) and 12(d)(1)(B), as well as from section 17(a) for the purchase of the guaranteed rate investment contract issued by an affiliate. As described above, we are rescinding only the portion of the exemptive orders granting fund of funds relief that falls within the scope of rule 12d1-4. We agree with commenters that the relief granted under sections 6(c) and 17(b) permitting investment in a fixed income instrument issued by an affiliate is distinct from the fund of funds relief granted in these orders. As noted above, we are not rescinding relief under section 17 when the relief does not implicate fund of funds arrangements. Accordingly, we are not rescinding this portion of the exemptive relief, which is unrelated to the fund of funds exemptive relief.

Transaction-Specific Relief. From time to time, we have granted exemptive relief to funds under section 12(d)(1) in order to engage in a transaction that might otherwise violate such provision. In many cases, this relief relates to fund reorganizations.[517] This transaction-specific relief does not involve ongoing fund of funds arrangements where the concerns underlying section 12(d)(1) are most

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515 Nationwide Comment Letter (referring to Nationwide Life Insurance Co., Investment Company Act Release Nos. 25492 (Mar. 21, 2002) (notice) and 25528 (Apr. 16, 2002) (order)).

516 Voya Comment Letter (referring to ING Partners Inc., et al., Investment Company Release Nos. 27116 (Oct. 12, 2005) (notice) and 27142 (Nov. 8, 2005) (order).

517 *See, e.g.* Allied Capital Corporation, et al., Investment Company Act Release Nos. 22902 (Nov. 21, 1997) (notice) and 22941 (order) (granting relief under sections 12(d)(1)(A) and 12(d)(1)(C), among other provisions, to allow for the acquisition of investment company subsidiaries in a merger).

pronounced and where the conditions of rule 12d1-4 will serve to protect investors against those concerns. As a result, we do not believe it is necessary to rescind such relief.

Grantor Trusts. One commenter requested we retain an exemptive order pertaining to current and future automatic common exchange security ("ACES") trusts.[518] ACES trusts are limited-life, grantor trusts. We have previously granted exemptive relief to funds and private funds to invest in a grantor trust (typically structured as a closed-end fund) in excess of the section 12(d)(1) limits, along with related relief.[519] The grantor trusts in this line of exemptive orders are not marketed to provide investors with either professional investment asset management or the benefits of investment in a diversified pool of assets. As a result, they do not result in the pyramiding of funds or the related potential abuses that the rule is designed to address, and therefore we are not rescinding this relief.

Fund of Funds Arrangements with Managed Risk Provision and other Relief Related to Section 12(d)(1)(E). One commenter requested that we not rescind a fund of funds exemptive order that permits a "managed risk" fund structure.[520] This commenter stated that the relief allows an insurance series fund that invests in one underlying fund in excess of the limits in section 12(d)(1)(A) also to invest in cash, cash equivalents, and certain hedging instruments in connection with a

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518 DPW Comment Letter (citing Goldman, Sachs & Co., Investment Company Act Release Nos. 32460 (Jan. 31, 2017) (notice) and 32514 (Feb. 28, 2017) (order) ("Goldman ACES Order")).

519 *See, e.g.,* Goldman ACES Order; *see also* J.P Morgan Securities Inc., Investment Company Act Release Nos. 24060 (Sept. 29, 1999) (notice) and 24112 (Oct. 26, 1999) (order).

520 *See* Capital Group Comment Letter (referring to the "managed risk fund provision" in American Funds Insurance Series, et al., Investment Company Act Release Nos. 31677 (June 17, 2015) (notice) and 31715 (July 14, 2015) (order)).

> risk-management strategy that is specifically designed to reduce the volatility of the acquiring fund. Because of the fund's investment in certain hedging instruments, the fund cannot rely on section 12(d)(1)(E) of the Act for purposes of an exception from the general prohibition against three tiers. We are not rescinding exemptive relief from sections 12(d)(1)(A) and (B) of the Act to the extent that the relief effectively allows a feeder fund to rely on section 12(d)(1)(E) without complying with certain aspects of section 12(d)(1)(E) of the Act. Accordingly, we believe this relief is outside the scope of rule 12d1-4 with respect to the treatment of a fund for purposes of the three-tier prohibition.[521]

We continue to believe that the one-year period for the termination of our fund of funds exemptive relief is sufficient to give adequate time for funds relying on impacted exemptive orders to bring their future operations into conformity with section 12(d)(1)(G) or rule 12d1-4.

The Commission does not believe that it is necessary to give individual hearings to the holders of the prior orders or to any other person.[522] This rule is prospective in effect and is intended to set forth for the entire industry the Commission's exemptive standards for these types of fund of funds arrangements. Funds are able to request Commission approval to operate as a fund of funds that does not meet the requirements of the rule.

As discussed in the 2018 FOF Proposing Release, our staff has previously stated that it would not recommend that the Commission take enforcement action in certain situations relating to section 12(d)(1). The 2018 FOF Proposing Release noted that the staff in the Division of

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521 In addition, we did not proposed to rescind exemptive relief related to section 12(d)(1)(F) and are not doing so. *See* FOF Proposing Release *supra* footnote 6 at 95.

522 *See also id.* at 97 (stating that "The Commission does not believe that it is necessary to give individual hearings to the holders of the prior orders or to any other person.").

Investment Management were reviewing staff letters relating to section 12(d)(1) to determine whether any such letters should be withdrawn in connection with any adoption of this rule. As we noted in the 2018 FOF Proposing Release, some of the letters may be moot, superseded, or otherwise inconsistent with the rule and, therefore, will be withdrawn.

The staff of the Division of Investment Management has issued a line of letters stating that the staff would not recommend enforcement action to the Commission under sections 12(d)(1)(A) or (B) of the Act if a fund acquires the securities of other funds in certain circumstances. We understand that certain industry practices have developed in connection with these letters. In particular, we understand that: (i) some funds have created three-tier master-feeder structures for tax management, cash management, or portfolio management purposes; (ii) other funds have invested in assets that may not be securities, but have otherwise complied with the restrictions in rule 12d1-2;[523] (iii) sponsors of UITs have deposited units of existing trusts into portfolios of future UIT series; (iv) foreign pension funds and profit sharing funds, and foreign subsidiaries and feeder funds have invested in other funds beyond the limits of section 12(d)(1); and (v) foreign funds have invested in other funds under section 12(d)(1) to the same extent as private funds.

In the 2018 FOF Proposing Release, we asked that commenters detail their concerns with the withdrawal of any of the letters. Commenters stated preferences for retaining certain no-

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[523] The Commission has previously issued exemptive orders to funds that rely on section 12(d)(1)(G) to allow those funds to invest in futures contracts and other financial instruments. *See*, *e.g.*, KP Funds, *et al.*, Investment Company Act Release Nos. 30545 (June 3, 2013) [78 FR 34413 (June 7, 2013)] (notice) and 30586 (July 1, 2013) (order); Financial Investors Trust and Hanson McClain Strategic Advisors, Inc., Release Nos. 30521 (May 15, 2013) [78 FR 30346 (May 22, 2013)] (notice) and 30554 (order). Following those orders, the staff of the Division of Investment Management issued a no-action letter stating that it would not recommend enforcement action to the Commission under section 12(d)(1)(A) or (B) of the Act against a fund of funds that meets all of the provisions of section 12(d)(1)(G) and rule 12d1-2, except to the extent that it invests in assets that might not be securities under the Act. *See, e.g.* Northern Lights Letter *supra* footnote 504.

action letters, including those that relate to three-tier structures, subject to the circumstances described in those letters.[524] Some commenters requested that no-action letters relating to a foreign fund that invests in a U.S. fund to comply with section 12(d)(l)(A)(i) but not sections 12(d)(l)(A)(ii) and (iii) not be withdrawn.[525] Other commenters suggested that certain no-action letters be retained related to the status of investment vehicles domiciled outside the U.S., where such foreign funds are acquired funds in fund of funds arrangements.[526] Commenters expressed views in favor of retaining no-action letters related to investments in three tier "central fund" structures.[527] Finally, other commenters requested that the staff publicly indicate specifically which no-action letters would be withdrawn.[528]

As a result of these considerations, the no-action letters stating that the staff would not recommend an enforcement action under specific circumstances related to section 12(d)(1) will be withdrawn one year from the effective date of the final rule. Importantly, as recognized above, the final rule provides a consistent and rules-based mechanism for fund of funds arrangements. As with the rescission of fund of funds exemptive orders, the withdrawal of staff no-action letters will include only those letters that fall within the scope of rule 12d1-4. With

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524 *See, e.g.* Thrivent Comment Letter; ICI Comment Letter.

525 Vanguard Comment Letter. The Commission previously stated that a foreign fund that uses U.S. jurisdictional means in the offering of securities it issues and relies on section 3(c)(1) or 3(c)(7) of the Act will be treated as a private fund for purposes of section 12(d)(1). *See* 2018 FOF Proposing Release, at footnote 52, *citing* "Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers," Investment Advisers Act Release No. 3222, at note 294 and accompanying text (June 22, 2011) [76 FR 39646 (July 6, 2011)]. Staff no-action letters stating that the staff would not recommend enforcement action if a foreign fund purchases securities of U.S. funds in excess of the limits of section 12(d)(1) under certain facts and circumstances will not be withdrawn. *See, e.g.,* Dechert LLP, SEC No-Action Letter (pub. avail. Aug. 4. 2009).

526 Ropes Comment Letter (citing Touche, Remnant & Co., SEC No-Action Letter (pub. avail. Aug. 27, 1984) and Red Rocks Capital, LLC, SEC No-Action Letter (pub. avail. Jun. 3, 2011) ("Red Rocks")); Blackrock Comment Letter (citing Red Rocks; The France Growth Fund, Inc., SEC Staff No-Action Letter (July 15, 2003); and Templeton Vietnam Opportunities Fund, Inc., SEC Staff No-Action Letter (Sept. 6, 1996).

527 Capital Group Comment Letter (noting reliance on Northern Lights Letter *supra* footnote 504).

528 *See, e.g.* Voya Letter.

respect to comments asking for specificity as to which no-action letters will be withdrawn, we refer commenters to the resource provided on the Division of Investment Management's website.[529]

IV. Other Matters

Pursuant to the Congressional Review Act,[530] the Office of Information and Regulatory Affairs has designated this rule a "major rule," as defined by 5 U.S.C. § 804(2). If any of the provisions of these rules, or the application thereof to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

V. Economic Analysis

We are mindful of the costs imposed by, and the benefits obtained from, our rules. Section 2(c) of the Investment Company Act states that when the Commission is engaging in rulemaking under the Investment Company Act and is required to consider or determine whether the action is necessary or consistent with the public interest, the Commission shall consider whether the action will promote efficiency, competition, and capital formation, in addition to the protection of investors. The following analysis considers, in detail, the potential economic effects that may result from the final rule,[531] including the benefits and costs to investors and other market participants as well as the broader implications of the final rule for efficiency, competition, and capital formation.

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529 *See supra* footnote 30.

530 5 U.S.C. § 801 *et seq*.

531 For purposes of this section, we use the term "final rule" to refer collectively to rule 12d1-4, the rescission of rule 12d1-2 and the exemptive orders, the amendment to rule 12d1-1, and the amendments to Form N-CEN.

A. Introduction

Rule 12d1-4 will allow funds to acquire the securities of another fund in excess of the limits in section 12(d)(1) of the Act without obtaining an exemptive order from the Commission. We are also rescinding rule 12d1-2 under the Act and certain exemptive relief, and amending rule 12d1-1 and Form N-CEN.[532]

The final rule will affect funds' investment flexibility, increase regulatory consistency and efficiency, and eliminate the need for acquiring and acquired funds to obtain an exemptive order from the Commission and incur the associated costs and delays. At the same time, the final rule will impose one-time costs on funds that will need to assess whether their operations are consistent with the final rule. In addition, the conditions in rule 12d1-4 will impose certain ongoing costs on funds, such as compliance, monitoring, and recordkeeping costs. Finally, certain funds will be required to restructure additional investments in other funds and incur the associated costs, such as transaction costs, to ensure compliance with the final rule.

B. Economic Baseline

The baseline against which the costs, benefits, and the effects on efficiency, competition, and capital formation of the final rule are measured consists of the current state of the fund market and the current regulatory framework for funds of funds.

1. Current State of the Funds Market

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532 We expect that the amendments to Form N-CEN will have immaterial economic effects. In particular, we expect that the amendments to Form N-CEN will increase the annual estimated burden hours associated with preparing and filing Form N-CEN by approximately 0.1 hours for each fund (*see infra* section VI.D). In addition, the amendments to Form N-CEN will facilitate the supervision and regulation of the fund industry, which will ultimately benefit fund investors, but any such effects are likely small. Hence, the economic analysis focuses on the economic effects of rule 12d1-4, the rescission of rule 12d1-2 and the exemptive relief, and the amendment to rule 12d1-1.

To establish a baseline for the economic analysis of the final rule, we provide descriptive statistics on the current state of the fund of funds market. In particular, we provide descriptive statistics on funds, investment advisers, sponsors, and depositors of funds, and fund investors because these are the persons that likely will be affected by the final rule.

First, we provide descriptive statistics on the number and size of funds and funds of funds.[533] We provide these statistics not only for funds of funds but also for single-tier funds to provide an understanding of the fund market as a whole and because the final rule will affect both current funds of funds and single-tier funds that may consider a fund of funds structure in the future. Master-feeder funds created in reliance on section 12(d)(1)(E) and funds that only acquire securities of money market funds in reliance on rule 12d1-1 are excluded from our analysis because these fund of funds structures are beyond the scope of rule 12d1-4.

Table 1 below shows the number and size of all funds and acquiring funds of funds using data from Form N-CEN filings as of May 2020.[534] A fund of funds in Form N-CEN is a fund

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533 We use Form N-CEN and Form N-PORT filings with the Commission as of May 2020 in our analysis. Form N-CEN provides census-type information on an annual basis and is filed by all registered investment companies, except for face amount certificate companies (rule 12d1-4 will not be available to face amount certificate companies). Form N-PORT provides portfolio holdings information on a monthly basis and is filed by registered management investment companies and ETFs organized as UITs. Hence, Form N-CEN provides information for the universe of potentially affected funds, with the exception of BDCs. Form N-PORT covers a subset of the potentially affected funds covered by Form N-CEN but it provides relevant portfolio holdings information for those funds, which is unavailable in Form N-CEN, and thus data from Form N-PORT yields additional insights on the fund market.

As of the data collection date, all fund groups file Form N-CEN but only large fund groups file Form N-PORT. Large fund groups are funds that, together with other investment companies in the same "group of related investment companies," have net assets of $1 billion or more as of the end of the most recent fiscal year of the fund. Filing Form N-PORT began in April 2020 for small fund groups, and this information became available to the Commission in July 2020, which was after the May 2020 cut-off date of our data analysis. However, we do not believe that such data would qualitatively change the results of our analysis. *See* Amendments to the Timing Requirements for Filing Reports on Form N-PORT, Investment Company Act Release No. 33384 (Feb. 27, 2019) [84 FR 7980 (Mar. 6, 2019)]. Nevertheless, large fund groups represent 84% of all fund groups in terms of total assets. *See infra* sections V.C.1.a.ii and V.C.1.b.v for discussion of differential effects of the rule on smaller relative to larger fund complexes.

534 Form N-CEN data does not allow us to identify and provide statistics on acquired funds. BDCs do not file reports on Forms N-CEN and so are excluded from Table 1. The UIT section of Form N-CEN currently

that acquires securities issued by any other investment company in excess of the amounts permitted under paragraph (A) of section 12(d)(1) of the Act but does not include a fund that acquires securities issued by money market funds solely in reliance on rule 12d1-1 under the Act.[535]

A trade association representing regulated investment companies globally provided the Commission with the results of a survey of its U.S. members and found that as of 2018, there were 1,359 funds of funds with $2.8 trillion in assets under management.[536] Of those funds, the survey observed that 31% (*i.e.*, 423 out of 1,359) of the funds of funds, representing $829 billion in assets, will not be affected by the final rule because they are structured solely in reliance on sections 12(d)(1)(E), 12(d)(1)(F), or 12(d)(1)(G), and the remaining 69% (*i.e.*, 936 out of 1,359)

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does not require a UIT to identify whether it is a fund of funds, and so we lack information on acquiring UITs using Form N-CEN data. We use the most recent Form N-CEN filing with the Commission for each fund between September 2018 and May 2020 for this analysis (*i.e.*, the first and last month with Form N-CEN data available as of the data collection date). We use all available Form N-CEN filings to also capture delinquent filers in our analysis. Approximately 5% of the funds in Table 1 were terminated during our sample period. Open-end funds, ETFs organized as open-end funds, and ETMFs are registered on Form N-1A. ETFs and ETMFs are identified using Item C.3.a.i and C.3.a.ii in Form N-CEN filings. Closed-end funds are registered on Form N-2. Variable annuity separate accounts organized as UITs are series, or classes of series, of trusts registered on Form N-4. Variable life insurance separate accounts organized as UITs are series, or classes of series, of trusts registered on Form N-6. ETFs registered as UITs are series, or classes of series, of trusts registered on Form N-8B-2. Non-ETF UITs are trusts registered on Forms N-4 or N-6. Management company separate accounts are trusts registered on Form N-3. The statistics in Table 1 are generally consistent with statistics on funds of funds provided by commenters. *See*, *e.g.*, ICI Comment Letter. One exception is a commenter that stated that as of March 2019, there were 496 closed-end funds with 236 billion in net assets. *See* Advent Comment Letter. We lack detailed information on commenter's estimation of these statistics but we believe that these statistics are lower than the statistics in Table 1 likely due to the different data sources and sample period used. *See* Table 4 of the Proposing Release for statistics of the number of acquiring funds by investment category.

535 Hence, acquiring funds in Table 1 includes: funds of funds that were structured in reliance on section 12(d)(1)(F); funds of funds that were structured in reliance on section 12(d)(1)(G); funds of funds that were structured in reliance on section 12(d)(1)(G) and rule 12d1-2; funds of funds that were structured in reliance on exemptive relief on which rule 12d1-4 is based; and funds of funds that were structured considering Commission staff letters.

536 *See* ICI Comment Letter.

of the funds of funds, representing $2.0 trillion in assets, will need to comply with the rule 12d1-4 conditions or restructure their investments.[537]

Another commenter, representing asset managers, conducted a survey of its members and found that all 15 surveyed sponsors, representing 655 funds of funds and assets of $1.8 trillion, stated that they rely on a variety of authorities (often in combination), including sections 12(d)(1)(F) (*i.e.*, five sponsors), section 12(d)(1)(G) (*i.e.*, 14 sponsors), rule 12d1-2 (*i.e.*, 14 sponsors), exemptive orders (*i.e.*, 14 sponsors), and/or structure funds of funds consistent with Commission staff no-action letters (*i.e.*, three sponsors).[538] All 15 sponsors indicated that they sponsor funds that invest in affiliated open-end funds and UITs;[539] 13 sponsors indicated that they sponsor funds that invest in unaffiliated open-end funds and UITs; four sponsors indicated

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537 For the purposes of this survey, a fund of funds is defined as a fund that invests in at least one other fund in excess of the limits of section 12(d)(1)(A) but does not include funds that only invest in money market funds. Hence, our definition of acquiring fund in Table 1 is similar to the definition of acquiring fund in the ICI survey. The ICI survey sample appears to be a subset of the sample of acquiring funds in Table 1. That is, the ICI sample represents approximately 79% of the acquiring funds in Table 1 (79% = 1,359 funds of funds in the ICI survey / 1,719 acquiring funds in Table 1). *See* ICI Comment Letter. Our data does not allow us to distinguish whether the acquiring funds in Table 1 have been structured in reliance on section 12(d)(1)(F); in reliance on section 12(d)(1)(G); in reliance on section 12(d)(1)(G) and rule 12d1-2; in reliance on an exemptive order; or considering Commission staff no-action letters.

538 *See* SIFMA AMG Comment Letter. For purposes of this survey, a fund of funds is a fund that invests substantially all of its assets (*i.e.*, > 85% of fund assets) in shares of other investment companies. The survey also requested information regarding funds that make investments in other investment companies beyond the limits of section 12(d)(1)(A) but where those investments, in the aggregate, represent less than 85% of fund assets. Fifty-nine of those funds hold more than 3% of an acquired fund's shares. Eight out of the 15 respondents sponsor funds that invest less than 85% of their assets in other funds, and those funds rely on a variety of authorities (often in combination), including section 12(d)(1)(F) (*i.e.*, three sponsors), section 12(d)(1)(G) (*i.e.*, seven sponsors), rule 12d1-1 (*i.e.*, three sponsors), exemptive orders (*i.e.*, eight sponsors), and/or rule 12d1-2 (*i.e.*, eight sponsors). All 8 sponsors indicated that they sponsor funds that invest in affiliated open-end funds and UITs; seven sponsors indicated that they sponsor funds that invest in unaffiliated open-end funds and UITs; three sponsors indicated that they sponsor funds that invest in affiliated central funds; two sponsors indicated that they sponsor funds that invest in unaffiliated closed-end funds; two sponsors indicated that they sponsor funds that invest in unaffiliated BDCs; one sponsor indicated that it sponsors funds that invest in unaffiliated unregistered funds; and one sponsor indicated that it sponsors funds that invest in affiliated unregistered funds. The data provided by the commenter is sponsor-level (rather than fund-level) data and so we cannot use this data to estimate how many of the acquiring and acquired funds in our sample will be affected by the final rule.

539 According to the survey, the funds of funds that invest in affiliated open-end funds in reliance on section 12(d)(1)(G) also invest in unaffiliated money market funds, unaffiliated registered investment companies, individual securities such as stocks and bonds, and non-securities such as certain derivatives or real estate.

that they sponsor funds that invest in affiliated central funds; two sponsors indicated that they sponsor funds that invest in affiliated unregistered funds; two sponsors indicated that they sponsor funds that invest in unaffiliated closed-end funds; one sponsor indicated that it sponsors funds that invest in unaffiliated BDCs; and one sponsor indicated that it sponsors funds that invest in unaffiliated unregistered funds.

Table 1: Descriptive statistics for all funds and acquiring funds using Form N-CEN filings

	Funds		Acquiring funds	
	Number	Net assets (bn $)	Number	Net assets (bn $)
Open-end funds	13,135	26,328	1,687	2,180
ETFs registered as open-end funds[540]	2,194	5,689	105	16
ETMFs registered as open-end funds	28	14	2	0.04
Closed-end funds	736	320	29	10
UITs	720	2,237	-	-
Variable annuity separate accounts registered as UITs	430	1,561	-	-
Variable life insurance separate accounts registered as UITs	243	165	-	-
ETFs registered as UITs	47	509	-	-
Management company separate accounts	14	225	3	0.05
Total	14,605	29,110	1,719	2,190

This table reports descriptive statistics for all funds and acquiring funds using data from Form N-CEN filings with the Commission as of May 2020. A fund of funds is a fund that acquires securities issued by any other investment company in excess of the amounts permitted under paragraph (A) of section 12(d)(1) of the Act but does not include a fund that acquires securities issued by money market funds solely in reliance on rule 12d1-1 under the Act (*see* Item C.3.e in Form N-CEN filings). Master-feeder funds are excluded from this analysis (*see* Item C.3.f in Form N-CEN). The UIT section of Form N-CEN currently does not require a UIT to identify if it is a fund of funds so information on acquiring UITs is marked as missing in this Table. For open-end funds, closed-end funds, and management company separate accounts, total net assets is the sum of monthly average net assets across all funds in the sample during the reporting period (*see* Item C.19.a in Form N-CEN). For UITs, we use the total assets as of the end of the reporting period (*see* Item F.11 in Form N-CEN), and for UITs with missing total assets information, we use the aggregated contract value for the reporting period instead (*see* Item F.14.c in Form N-CEN).

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540 The reported net assets of ETFs registered as open-end funds in Table 1 likely are overstated because reporting on whether or not a fund is an ETF on Form N-CEN is at the series level, not the class level. Hence, all share classes within an open-end fund that has ETF share classes are attributed to the ETF category.

Table 2 below shows the number and size of funds, acquiring funds, and acquired funds using data from Form N-PORT filings with the Commission as of May 2020.[541] Form N-PORT is only filed by registered management investment companies and ETFs that are organized as UITs. Hence, the sample of funds in Table 2 (*i.e.*, registered management investment companies and ETFs organized as UITs) is narrower than the sample of funds in Table 1 (*i.e.*, all registered investment companies) because Form N-CEN and Form N-PORT do not apply to the same scope of funds.[542] Each acquiring fund represented in Table 2 is a registered management investment company or ETF organized as a UIT that invests a non-zero percentage of its assets in registered investment companies or BDCs, while each acquired fund is a registered investment company in which a registered management investment company or ETF organized as a UIT invests.[543] Hence, the definition of acquiring funds in Table 1 is broader than the definition of acquiring funds in Table 2.[544]

Untabulated analysis shows that out of the 4,750 acquiring funds in Table 2, 1,435, or 30%, invested in at least one acquired fund beyond the limits of section 12(d)(1).[545] These 1,435

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541 BDCs do not file reports on Form N-PORT and are therefore excluded from the definition of acquiring funds in Tables 2 and 3. We use the most recent Form N-PORT filing with the Commission for each fund filed between May 2019 and May 2020 for this analysis (*i.e.*, the first and last month with Form N-PORT data available as of the data collection date). *See supra* footnote 534 for definition of fund categories. Total net assets in Form N-CEN may be different from total net assets in Form N-PORT because Form N-CEN reports average assets estimated over the reporting period while Form N-PORT reports point-in-time assets as of the reporting date.

542 *See supra* footnote 534.

543 Hence, acquiring funds in Table 2 includes funds of funds that were structured in reliance on section 12(d)(1)(A), funds of funds that were structured in reliance on section 12(d)(1)(F), funds of funds that were structured in reliance on section 12(d)(1)(G), funds of funds that were structured in reliance on exemptive relief on which rule 12d1-4 is based, and funds of funds that were structured considering Commission staff letters.

544 The Form N-PORT data allows us to use a broader definition of acquiring funds in Table 2 compared to Table 1 (i) to provide a more complete picture of the fund of funds market; and (ii) for comparability purposes with the acquiring fund statistics in the 2018 FOF Proposing Release.

545 We define acquiring funds that invest in at least one acquired fund beyond the limits of section 12(d)(1) using Form N-CEN data as of May 2020.

acquiring funds invested, on average, in nine unique acquired funds beyond the section 12(d)(1) limits.

Also, untabulated analysis shows that 954, or 20%, of all acquiring funds in Table 2 appear to be relying on the statutory exemption in section 12(d)(1)(G) to structure a fund of funds arrangement.[546] Finally, untabulated analysis shows that from the 16,797 acquiring-acquired fund pairs in Table 2, for which the acquiring fund invests in the acquired fund beyond the limits of section 12(d)(1)(A), 7,400 acquiring-acquired fund pairs have a different primary investment adviser.[547]

As Table 2 shows, there were 2,151 unique top-tier acquiring funds in multi-tier (*i.e.*, more than two-tier) fund of funds structures and 986 unique second-tier acquired funds in multi-tier fund of funds structures.[548] Out of the 2,151 unique top-tier acquiring funds in multi-tier structures in Table 2, untabulated analysis shows that 721 are top-tier acquiring funds in structures that are four tiers or more, 149 are top-tier acquiring funds in structures that are five tiers or more, and 78 are top-tier acquiring funds in structures that are six tiers.[549] In the case of

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546 We define 12(d)(1)(G) acquiring funds as open-end funds or UITs that invest at least 10% of their assets in other open-end funds or UITs that are in the same group of investment companies. We identify funds that are in the same group of investment companies using Item B.5 in Form N-CEN filings with the Commission as of May 2020. On one hand, our methodology may overestimate the number of 12(d)(1)(G) acquiring funds to the extent that certain funds rely on exemptive orders rather than 12(d)(1)(G) to invest in funds within the same group of investment companies beyond the limits of section 12(d)(1)(A). On the other hand, our methodology may underestimate the number of 12(d)(1)(G) acquiring funds because the definition of the group of investment companies in Form N-CEN is narrower than the definition under 12(d)(1)(G). In particular, "[f]amily of investment companies" is defined in Item B.5 of Form N-CEN as any two or more registered funds that (i) share the same investment adviser or principal underwriter; and (ii) hold themselves out to investors as related companies for purposes of investment and investor services. "Group of investment companies" is defined in section 12(d)(1)(G) as any two or more registered funds that hold themselves out to investors as related companies for purposes of investment and investor services. *See* 15 U.S.C. 80a-12(d)(1)(G)(ii).

547 Based on investment adviser data in Item C.9 of Form N-CEN as of May 2020.

548 The 2,151 top-tier acquiring funds in multi-tier structures include funds of funds that are structured both within and beyond the limits of section 12(d)(1).

549 We have not identified any multi-tier structures that are more than 6 tiers.

four-tier structures, the average investment of the top-tier acquiring fund in the fourth-tier acquired funds is equal to 0.006% of the top-tier acquiring fund's assets; in the case of five-tier structures, the average investment of the top-tier acquiring fund in the fifth-tier acquired funds is equal to 0.00006% of the top-tier acquiring fund's assets; and in the case of six-tier structures, the average investment of the top-tier acquiring fund in the sixth-tier acquired funds is practically zero.[550]

When looking at only multi-tier structures in which at least one acquiring fund in each level invests in at least one acquired fund beyond the limits of section 12(d)(1), there are 23 top-tier acquiring funds in structures that are three tiers or more and one top-tier acquiring fund in a structure that is four tiers.[551] In the case of the 23 top-tier acquiring funds in multi-tier structures that are three tiers or more, the average investment of the top-tier acquiring fund in the third-tier acquired funds is equal to 2.93% of the top-tier acquiring fund's assets, and in the case of the one top-tier acquiring fund in a multi-tier structure that is four tiers, the average investment of the top-tier acquiring fund in the fourth-tier acquired funds is equal to 0.00003% of the top-tier acquiring fund's assets.[552]

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550 We estimate the top-tier acquiring fund's investment in the bottom-tier acquired funds by accounting for the top-tier acquiring fund's investment in the second-tier acquired funds, the second-tier acquired funds' investments in the third-tier acquired funds, and so on. For example, in the case of three-tier structures, if the top-tier acquiring fund invests 5% of its assets in one second-tier acquired fund, and the second-tier acquired fund invests 5% of its assets in one third-tier acquired fund, then the top-tier acquiring fund's investment in the bottom-tier acquired fund is equal to 0.25% = 5% x 5%.

551 We define acquiring funds that invest in at least one acquired fund beyond the limits of section 12(d)(1) using Form N-CEN data as of May 2020. There are no multi-tier funds of funds beyond four tiers that are structured beyond the limits of section 12(d)(1). Our data does not allow us to distinguish whether the identified multi-tier structures were structured in reliance on one of the exceptions to the complex structures condition in our exemptive orders.

552 *See supra* footnote 550.

A commenter also observed that as of 2018, out of the 1,359 funds of funds representing $2.8 trillion in assets under management, 198 funds of funds representing $287 billion in assets under management utilized a multi-tier structure.[553]

Another commenter found that out of the 655 funds of funds[554] that were sponsored by 15 survey respondents, 223, or 34%, hold more than 3% of an acquired fund's shares.[555] The commenter also found that out of the 15 surveyed sponsors, eight sponsors, or 53%, indicated that they employ multi-tier structures.[556] Out of the eight sponsors that employ multi-tier structures, seven sponsors employ three-tiered structures, and one sponsor employs a four-tiered structure. Seven sponsors operate these multi-tier structures pursuant to exemptive orders; three sponsors rely on section 12(d)(1)(G); three sponsors rely on rule 12d1-2; two sponsors rely on section 12(d)(1)(A); two sponsors structure funds considering staff no-action letters; one sponsor relies on section 12(d)(1)(F); and one sponsor relies on rule 12d1-1.[557]

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553 *See* ICI Comment Letter. The proportion of acquiring funds that are top-tier acquiring funds in multi-tier structures in Table 2 (*i.e.*, 45% = 2,151 / 4,750) is different from the proportion of acquiring funds that are top-tier acquiring funds in multi-tier structures provided by the commenter (*i.e.*, 15% = 198 / 1,359) potentially due to different definitions of acquiring funds and top-tier acquiring funds in multi-tier structures. In particular, the commenter defines acquiring funds as funds that invest in at least one other fund in excess of the limits of section 12(d)(1)(A) while Table 2 defines acquiring funds as funds that invest a non-zero percentage of their assets in other funds. The commenter does not provide information on how it defines top-tier acquiring funds in multi-tier structures.

554 *See supra* footnote 537 for the commenter's definition of funds of funds.

555 *See* SIFMA AMG Comment Letter. The 34% (= 223 / 655) of acquiring funds that invest in other funds beyond the limits in section 12(d)(1) provided by the commenter is higher than our 30% (= 1,435 / 4,750) estimate using Form N-PORT and Form N-CEN data, and the difference may be due to the different samples used for the two analyses.

556 *See* SIFMA AMG Comment Letter. The commenter provided statistics on multi-tier structures in terms of sponsors (rather than funds), and so we are unable to compare with precision the statistics provided by the commenter to our statistics on multi-tier structures in Table 2. Nevertheless, the 53% of surveyed sponsors employing multi-tier structures is largely consistent with the 45% (= 2,151 / 4,750) of acquiring funds that are top-tier acquiring funds in multi-tier structures in Table 2.

557 *See* SIFMA AMG Comment Letter. The data provided by the commenter is sponsor-level (rather than fund-level) data and so we cannot use this data to estimate how many of the multi-tier structures in our sample will be affected by the final rule or the extent to which they will be affected. In addition, our data does not allow us to distinguish whether the multi-tier structures in our sample were created in reliance on

Table 2: Descriptive statistics for funds, acquiring funds, and acquired funds using Form N-PORT filings

Panel A: Statistics on funds, acquiring funds, and acquired funds

	Funds		Acquiring funds		Acquired funds	
	Number	Net assets (bn $)	Number	Net assets (bn $)	Number	Net assets (bn $)
Open-end funds	11,170	24,458	4,514	8,349	2,925	14,743
ETFs	1,898	6,361	649	2,364	729	6,053
ETMFs	21	18	4	3	3	17
Closed-end funds	600	310	231	115	458	242
ETFs registered as UITs	5	436	-	-	4	436
UITs registered as separate accounts	-	-	-	-	5	50
Management company separate accounts	13	208	5	144	-	-
Total	11,788	25,412	4,750	8,608	3,392	15,471

Panel B: Statistics on multi-tier structures

	Multi-tier structures	
	Number of acquiring funds	Number of acquired funds
Open-end funds	2,074	813
ETFs	148	278
ETMFs	2	1
Closed-end funds	74	173
ETFs registered as UITs	-	-
UITs registered as separate accounts	-	-
Management company separate accounts	3	-
Total	2,151	986

This table reports descriptive statistics for all funds, acquiring funds, and acquired funds using data from Form N-PORT filings with the Commission as of May 2020. Panel A presents statistics on all funds, acquiring funds, and acquired funds, and Panel B presents statistics on multi-tier structures. A fund of funds is a fund that invests a non-zero percentage of its assets in securities issued by other registered investment companies but does not include a fund that solely invests in money market funds. Master-feeder funds, defined as structures where the acquiring fund invests more than 98% of its assets in another registered investment company, are excluded from this analysis. Multi-tier structures are funds of funds with more than two tiers. Acquiring funds in multi-tier structures are the unique top-tier acquiring funds in a multi-tier structure, and acquired funds in multi-tier structures are the unique second-tier acquired funds in multi-tier structures. Total net assets is the sum of total net assets across all funds in the sample during the reporting period (*see* Item B.1.c in Form N-PORT).

sections 12(d)(1)(A), 12(d)(1)(F), 12(d)(1)(G), rule 12d1-2, exemptive orders, or considering staff no-action letters.

Our review of BDC filings show that as of December 2019, there were 83 BDCs with $123 billion in total gross assets, out of which 45 BDCs with 83 billion in total gross assets were listed on a national securities exchange.[558] Approximately 44% of the BDCs were acquiring BDCs and 60% were acquired BDCs in fund of funds structures.[559] We have not granted exemptive relief to BDCs as acquiring funds so we believe that all acquiring BDCs invest in other funds within the 12(d)(1) limits.

Table 3 below shows the percentage of acquiring funds that invest between 0 and 5%, 5 and 10%, 10 and 25%, 25 and 50%, 50 and 75%, 75 and 90%, 90 and 95%, and above 95% of their total assets in other funds as of May 2020.[560] The table shows that the majority of acquiring funds invest either less than 10% or more than 95% of their assets in other funds. The reason for the concentration of acquiring funds below the 10% level is likely that a 10% investment in other funds is within the section 12(d)(1)(A) statutory limits. Funds that invest above the 95%

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558 Estimates of the number of BDCs and their gross assets are based on a staff analysis of Form 10-K and Form 10-Q filings as of December 2019, which are the most recent available filings as of the data collection date. Our estimates exclude BDCs that may be delinquent or have filed extensions for their filings, wholly-owned subsidiaries of other BDCs, and BDCs in master-feeder structures. These statistics are generally consistent with statistics on BDCs provided by commenters. *See*, *e.g.*, SBIA Comment Letter; IPA Comment Letter.

559 We define acquiring BDCs as BDCs that reported non-zero AFFEs in Forms 497, N-2, or N-2A filed with the Commission between January 2019 and May 2020. 44% = 14 BDCs that reported non-zero AFFEs in Forms 497, N-2, or N-2A filed with the Commission between January 2019 and May 2020 / 32 BDCs that filed Forms 497, N-2, or N-2A with the Commission between January 2019 and May 2020. Only BDCs traded on an exchange file Forms 497, N-2, or N-2A. The remaining BDCs file Forms 10-K but BDCs are not required to report their AFFEs on Form 10-K. For those BDCs that did not file a Form 497, N-2, or N-2A with the Commission between January 2019 and May 2020, our review of the schedule of investment companies in Forms 10-K filed with the Commission between January 2019 and May 2020 yielded one acquiring BDC additional to the 14 acquiring BDCs identified from our review of Forms 497, N-2, or N-2A. We estimate the number of acquired BDCs using Form N-PORT filings as of May 2020. 60% = 50 BDCs acquired BDCs identified using Form N-PORT data as of May 2020 / 83 BDCs that filed forms 10-K or 10-Q as of December 2019.

560 In addition to other funds, acquiring funds may invest in private funds, cash and cash equivalents, derivatives, individual equity and debt securities, asset-backed securities, etc. We do not aggregate fund holdings across advisory groups for the purposes of this analysis.

threshold likely rely either on section 12(d)(1)(G) or (F) or on exemptive orders to invest in other funds beyond the section 12(d)(1)(A) statutory limits.

Table 3: Percentage of acquiring funds that invest certain % of their assets in other funds

	[0-5%]	(5-10%]	(10-25%]	(25-50%]	(50-75%]	(75-90%]	(90-95%]	above 95%
Open-end funds	47%	8%	7%	8%	4%	5%	3%	17%
ETFs	70%	2%	4%	6%	4%	6%	2%	6%
ETMFs	25%	25%	0%	25%	25%	0%	0%	0%
Closed-end funds	82%	6%	7%	1%	2%	0%	0%	0%
Management company separate accounts	100%	0%	0%	0%	0%	0%	0%	0%

This table reports the percentage of acquiring funds by fund type that invest between 0 and 5%, 5 and 10%, 10 and 25%, 25 and 50%, 50 and 75%, 75 and 90%, 90 and 95%, and above 95% of their total assets in other funds using data from Form N-PORT filings with the Commission as of May 2020. UITs, except for ETFs registered as UITs, do not file Form N-PORT filings with the Commission and thus are excluded from this table. We have not identified any ETFs registered as UITs that are acquiring funds. Fund investments in money market funds and master-feeder structures are excluded from this analysis. Percentages may not sum up to 100 due to rounding error.

The total net assets of funds of funds have generally increased over time. According to the 2020 ICI Fact Book, the total net assets of open-end funds of funds increased from $680 billion to $2.54 trillion between December 2009 and December 2019, and the total net assets of exchange-traded funds of funds increased from $824 million to $13,444 million between December 2009 and December 2019.[561]

Table 4 Panel A shows descriptive statistics for the expense ratio, front-end load, and deferred charges for single-tier funds (*i.e.*, all funds excluding acquiring funds), and Table 4 Panel B shows descriptive statistics for the expense ratio, front-end load, and deferred charges for acquiring funds as of July 2020.[562] The expense ratio in Table 4 includes acquired fund fees

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561 Open-end funds of funds are open-end funds that invest primarily in other open-end funds. ETF funds of funds are ETFs that invest primarily in other ETFs. *See* 2020 ICI Fact Book, *supra* footnote 4, at 206 and 244.

562 In Table 4 and Figure 1 of this release (*i.e.*, fee and expense analysis), we identify acquiring funds (excluding BDCs) using Morningstar Holdings data instead of Form N-CEN or Form N-PORT data, similar to Table 3 and Figure 1 of the Proposing Release. The reason is that Form N-CEN and Form N-PORT data

and expenses. Untabulated analysis based on the expense data in Table 4 shows that the equal-weighted average expense ratio for acquiring open-end funds, UITs, and ETFs is statistically significantly higher than the equal-weighted average expense ratio for single-tier open-end funds, UITs, and ETFs, respectively.[563] For BDCs and registered closed-end funds, there is no statistically significant difference in the operating expenses of acquiring and single-tier funds. There are no acquiring ETMFs with expense data in our sample. Our results are qualitatively similar when we compare the value-weighted (instead of the equal-weighted) average of the expense ratio for single-tier and acquiring funds. Nevertheless, the results of the statistical comparison of the expense ratio for single-tier and acquiring funds should be interpreted with caution because our analysis does not control for differences in the characteristics of single-tier and acquiring funds, such as differences in their investment strategy, which could potentially affect fund fees and expenses.

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only becomes available in 2019 but the analysis in Figure 1 requires identification of acquiring funds starting from 2015. We use the same data to identify acquiring funds in both Table 4 and Figure 1 to allow for data comparability in the fee and expense analysis. We define acquiring BDCs as BDCs that reported non-zero AFFEs in Forms 497, N-2, or N-2A filed with the Commission between January 2019 and May 2020 (*see supra* footnote 559). The number of observations in Table 4 is different than the number of observations in Table 1 because (i) we lack expense data for some of the funds; and (ii) there are differences in the unit of observation in Morningstar and Form N-CEN (*see infra* footnote 564).

563 We use a two-tailed t-test and a 95% confidence interval to examine whether the differences in the equal-weighted averages of fees and expenses for acquiring and single-tier funds are statistically significant. A 95% confidence interval is frequently used for hypothesis testing in scientific work (*see*, *e.g.*, David H. Kaye & David A. Freedman, *Reference Guide on Statistics*, in The Reference Manual on Scientific Evidence (2nd ed., 2000), at 83).

Table 4: Expense ratio, front-end load, and deferred charges for single-tier and acquiring funds

Panel A: Single-tier funds

	Expense Ratio				
	Equal-weighted mean	Value-weighted mean	Median	Standard deviation	N
Open-end funds	0.92	0.47	0.89	0.47	5,124
UITs[564]	0.32	0.30	0.26	0.30	3,316
ETFs	0.52	0.13	0.49	0.32	2,003
ETMFs	0.74	0.77	0.78	0.25	16
Closed-end funds	2.29	1.96	1.86	1.90	192
Management company separate accounts	0.33	0.35	0.32	0.03	7
BDCs[565]	12.00	11.00	12.20	4.17	18

	Front-End Load				
	Equal-weighted mean	Value-weighted mean	Median	Standard deviation	N
Open-end funds	1.42	1.67	0.83	1.44	2,490
UITs	3.72	3.16	3.90	1.04	1,342
ETFs	-	-	-	-	-
ETMFs	-	-	-	-	-
Closed-end funds	2.13	1.61	1.57	1.97	19
Management company separate accounts	-	-	-	-	-
BDCs	2.98	2.92	2.00	1.87	9

	Deferred Charges				
	Equal-weighted mean	Value-weighted mean	Median	Standard deviation	N
Open-end funds	0.05	0.04	0.03	0.07	2,035
UITs	1.86	1.94	2.18	0.56	1,784
ETFs	-	-	-	-	-
ETMFs	-	-	-	-	-
Closed-end funds	0.12	0.16	0.13	0.08	5
Management company separate accounts	-	-	-	-	-

564 The difference in the number of UITs reported in Table 1 compared to Table 4 is likely due to the fact that Form N-CEN data (*i.e.*, Table 1) is aggregated at the trust level while Morningstar (*i.e.*, Table 4) reports unique UIT series, which we are unable to aggregate at the trust level due to data limitations.

565 The BDC expense ratio statistics are higher in Table 4 of this release compared to Table 3 of the 2018 FOF Proposing Release. In the 2018 FOF Proposing Release we collected BDC expense data from the most recent available Forms 497, N-2, or N-2A, while in this release we collect BDC expense data only from Forms 497, N-2, or N-2A that were filed between January 2019 and May 2020 to avoid using stale data in our analysis.

BDCs	-	-	-	-	-

Panel B: Acquiring funds

	Expense Ratio				
	Equal-weighted mean	Value-weighted mean	Median	Standard deviation	N
Open-end funds	0.98	0.56	0.91	0.57	2,837
UITs	1.71	1.56	1.79	0.88	874
ETFs	0.63	0.20	0.54	0.40	503
ETMFs	-	-	-	-	-
Closed-end funds	2.07	1.91	1.91	0.79	79
Management company separate accounts	-	-	-	-	-
BDCs	12.02	10.06	12.98	3.89	14

	Front-End Load				
	Equal-weighted mean	Value-weighted mean	median	Standard deviation	N
Open-end funds	1.43	1.28	0.86	1.47	1,359
UITs	1.00	1.00	1.00	0.00	19
ETFs	-	-	-	-	-
ETMFs	-	-	-	-	-
Closed-end funds	1.24	1.08	1.13	1.02	11
Management company separate accounts	-	-	-	-	-
BDCs	2.75	2.00	2.00	1.82	5

	Deferred Charges				
	Equal-weighted mean	Value-weighted mean	Median	Standard deviation	N
Open-end funds	0.08	0.05	0.04	0.09	1,066
UITs	2.09	2.14	2.25	0.46	872
ETFs	-	-	-	-	-
ETMFs	-	-	-	-	-
Closed-end funds	0.30	0.16	0.32	0.16	3
Management company separate accounts	-	-	-	-	-
BDCs	-	-	-	-	-

This table reports descriptive statistics for the expense ratio, front-end load, and deferred charges in percentage points for single-tier funds (*i.e.*, all funds excluding acquiring funds) in Panel A, and for acquiring funds in Panel B as of July 2020. Expense ratio is the percentage of fund assets, net of reimbursements, used to pay for operating expenses and management fees, including 12b-1 fees, administrative fees, and all other asset-based costs incurred by the fund, except brokerage costs. Sales charges are not included in the expense ratio. The expense ratio for acquiring funds is retrieved from the acquiring fund's prospectus and it includes the acquired funds' expense ratio. The front-end load is a one-time deduction from an investment made into the fund. Deferred charges are imposed when investors redeem shares. The analysis is conducted at the fund level using asset-

weighted average values for multiple-class portfolios. We exclude funds with zero expense ratios, front-end loads, and deferred charges for the estimation of the descriptive statistics in each respective panel. There are no acquiring ETMFs with expense ratio data in our sample. There are also no acquiring management company separate accounts in our sample. ETFs, ETMFs, and management company separate accounts do not charge front-end loads or deferred charges. BDCs charge a front-end load, which includes selling commissions and dealer management fees, but they do not charge deferred charges. We identify acquiring open-end funds, UITs, ETFs, ETMFs, and closed-end funds using Morningstar Holdings data and acquiring BDCs as BDCs that reported non-zero AFFEs in Forms 497, N-2, or N-2A filed with the Commission between January 2019 and May 2020. Expense data for open-end funds, UITs, ETFs, ETMFs, and closed-end funds is retrieved from Morningstar Direct, and data for BDCs is retrieved from Forms 497, N-2, or N-2A. Data is winsorized at the 1% and 99% levels, with the exception of the BDC data, which is not winsorized because there are no outliers.

There is some evidence of a decrease in the expense ratio for certain funds of funds over time. In particular, according to an ICI report, the equal-weighted (value-weighted) average of the expense ratio of target date open-end funds has decreased from 1.23% (0.67%) in 2008 to 0.78% (0.37%) in 2019.[566]

Figure 1 Panels A–C below show the equal-weighted average of the expense ratio for acquiring open-end funds, ETFs, and closed-end funds between 2015 and 2019.[567] Due to data limitations, the expense ratio in Figure 1 does not include acquired fund fees and expenses. As Panel A shows, the expense ratio for open-end acquiring funds has decreased from 0.91 in 2015 to 0.80 in 2019, but this decrease is not statistically significant.[568] As Panel B shows, the expense ratio for acquiring ETFs has increased from 0.51 in 2015 to 0.53 in 2019, with a peak equal to 0.57 in 2016, but this decrease is not statistically significant. Finally, as Panel C shows, the expense ratio of closed-end acquiring funds has monotonically increased from 1.39 in 2015 to 2.31 in 2019 and this increase is statistically significant at the 1% level. The time-series

566 *Trends in the Expenses and Fees of Funds, 2019*, ICI RES. PERSP., Mar. 2020, at 13.

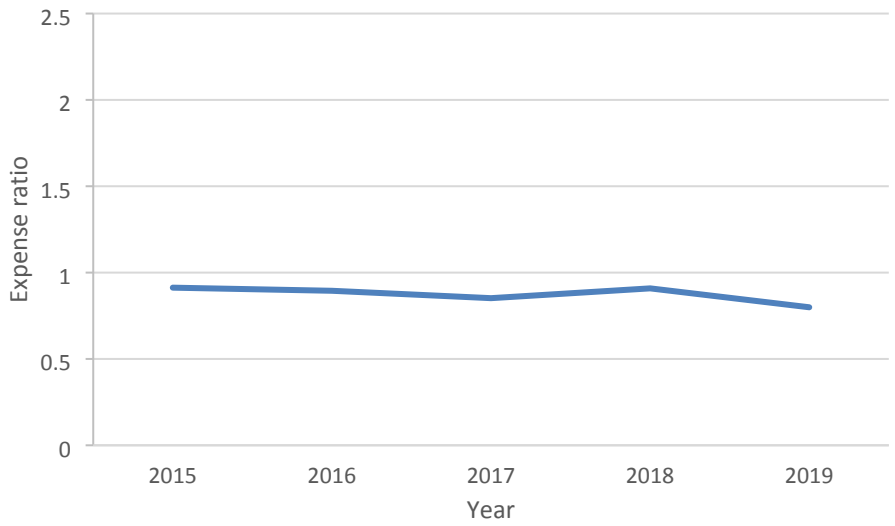
567 *See supra* footnote 552 for definition of acquiring funds.

568 In this and all subsequent analysis, to examine if there is a statistically significant time trend in the data, we regress the variable of interest to a year trend variable, and we test whether the coefficient on the trend variable is statistically different from zero. We use a two-tailed t-test and a 95% confidence interval. *See supra* footnote 563.

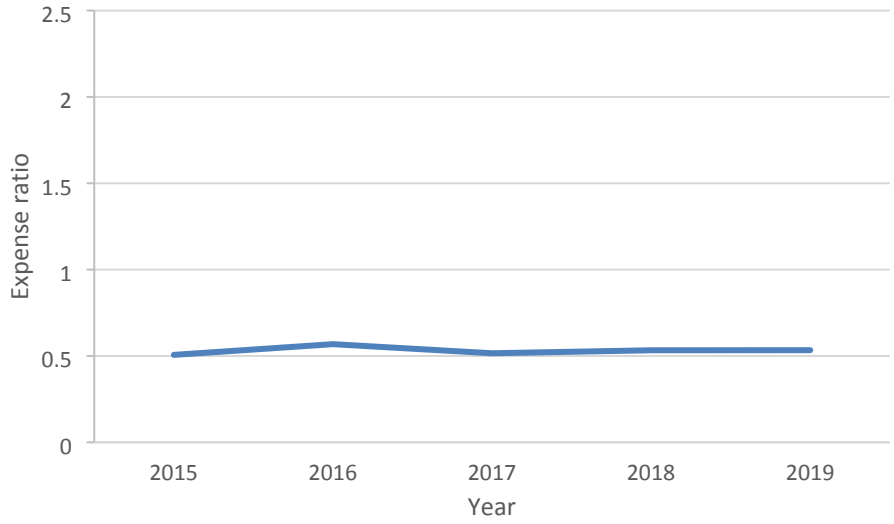
trends for the expense ratio of acquiring ETFs and closed-end funds are qualitatively similar when we examine the value-weighted (instead of the equal-weighted) average of the expense ratio whereas the trend for the expense ratio of acquiring open-end funds exhibits a slight increase although this is not statistically significant.

Figure 1: Equal-weighted average of acquiring funds' expense ratio over time

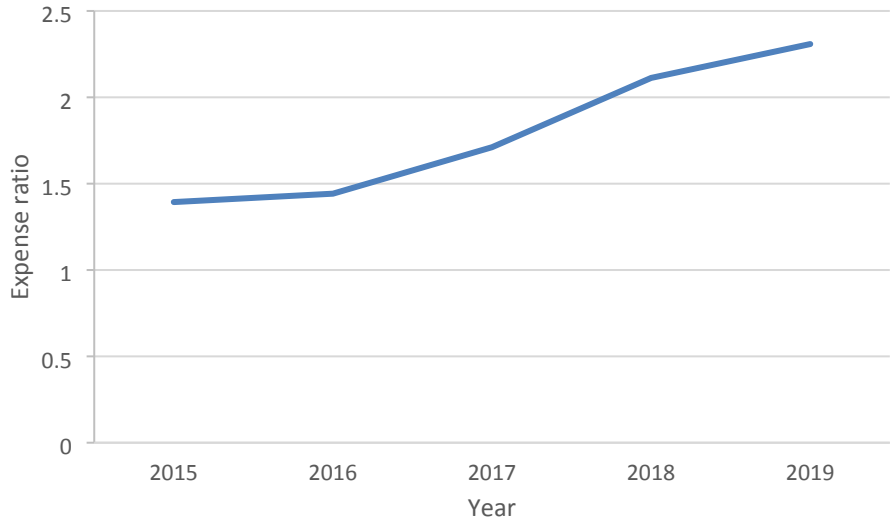
Panel A: Open-end acquiring funds



Panel B: Exchange-traded acquiring funds



Panel C: Closed-end acquiring funds



This figure reports the equal-weighted average of the expense ratio for acquiring funds by fund type between 2015 and 2019. Panel A shows the average expense ratio for open-end funds, Panel B for ETFs, and Panel C for closed-end funds. There are no acquiring ETMFs with expense data in our sample and there is no historical structured data for the expense ratio of UITs and BDCs. The analysis is conducted at the fund level using asset-weighted average values for multiple-class portfolios. Expense ratio is the percentage of fund assets, net of reimbursements, used to pay for operating expenses and management fees, including 12b-1 fees, administrative fees, and all other asset-based costs incurred by the fund, except brokerage costs. The expense ratio is retrieved from the acquiring fund's annual report and it does not include the acquired funds' fees and expenses. We identify acquiring funds using Morningstar Holdings data. Expense data is retrieved from Morningstar Direct and is winsorized at the 1 and 99% levels.

As a baseline for understanding the effects of the voting provisions of rule 12d1-4 on acquiring funds, we study how frequently funds held shareholder meetings in 2019. Our review of filings with the Commission showed that 12% of all open-end funds, no UITs, 68% of all closed-end funds, and 86% of BDCs held at least one shareholder meeting in 2019.[569] Further, 12% of the acquired open-end funds, no acquired UITs, 92% of the acquired closed-end funds, and 94% of the acquired BDCs held at least one shareholder meeting in 2019.[570]

The final rule will also affect investment advisers to funds. As of March 2020, there were 1,720 investment advisers that provide portfolio management services to registered investment companies and BDCs and these investment advisers managed assets equal to $28,629 billion.[571] Approximately 17% of all investment advisers provided portfolio management services to acquiring funds and 33% to acquired funds.[572]

The final rule will also affect UIT depositors and sponsors. As of May 2020, there are 150 UIT unique depositors and 14 unique UIT sponsors.[573]

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569 We identify funds that held a shareholder meeting in 2019 as funds that filed at least one Form DEF14A with the Commission in 2019. Our sample of funds is the same as in Table 1 above. Acquired funds are defined as in Table 2 above.

Separate accounts are excluded from this analysis because rule 12d1-4 will not include specific voting provisions when an insurance product separate account is part of the acquiring fund advisory group or acquiring fund sub-advisory group.

570 Our sample of acquired funds is the same as in Table 2 above.

571 Based on Item 5.D. of Form ADV filed with the Commission as of March 2020.

572 Based on Item C.9. of Form N-CEN filed with the Commission as of May 2020. Our sample of acquiring funds is the same as in Table 1 above and the sample of acquired funds is the same as in Table 2 above. BDCs do not file Form N-CEN and thus are excluded from this analysis.

573 Based on Items F.1 and F.4 of Forms N-CEN filed with the Commission as of May 2020. We lack data on acquiring UITs and so we do not provide counts of depositors and sponsors to acquiring UITs (*see supra* Tables 1 and 2).

Lastly, the final rule will impact current and prospective individual investors that invest in funds. As of December 2019, there were 59.7 million U.S. households and 103.9 million individuals that owned U.S. registered investment companies.[574]

2. Current Regulatory Framework

The existing regulatory framework for funds of funds comprises the current set of statutory provisions and rules governing funds of funds, the exemptive orders we have granted to allow certain funds of funds, and certain industry practices that have developed in connection with staff-level views provided in certain staff no-action letters. Below we discuss in more detail the fund of funds exemptive order process[575] and we list the current set of statutory provisions and rules governing funds of funds as well as relevant staff no-action letters.[576]

a. Exemptive Order Process

Certain funds rely on individual exemptive orders granted by the Commission to invest in other funds beyond the limits of section 12(d)(1). The process of obtaining an exemptive order imposes direct administrative costs on funds associated with the preparation and revision of an application and consultations with Commission staff. We estimate that the administrative cost associated with obtaining an exemptive order permitting an acquiring fund to invest in an acquired fund beyond the limits of section 12(d)(1) is approximately $100,000.[577] Once a fund adviser/sponsor obtains exemptive relief to structure a fund of funds, the adviser/sponsor may

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574 *See* 2020 ICI Fact Book, *supra* footnote 4.

575 *See supra* section II.C and *infra* section V.C.1.b for detailed discussion of the exemptive order conditions.

576 *See supra* section I.A for detailed discussion of the relevant statutory provisions and rules and *supra* sections II.C.3.d and III for detailed discussion of relevant staff no-action and interpretive letters.

577 The $100,000 estimate reflects the current administrative cost associated with obtaining an exemptive order. This cost may decrease following the adoption of amendments to establish an expedited review procedure for applications for orders that are substantially identical to recent precedent. *See infra* note 579 and associated text.

apply this relief to multiple funds of funds. The administrative cost associated with the exemptive order process may be shared between the fund adviser/sponsor and the fund, and thus this administrative cost may be passed down to investors in the form of management fees or expenses. Nevertheless, we lack data and the commenters did not provide any data that would allow us to estimate how the administrative cost associated with the exemptive order process is split between the fund adviser/sponsor and the fund.

The exemptive order process also imposes indirect costs on funds and their advisers/sponsors because it introduces delays and uncertainty to fund investments. For non-ETF (ETF) fund of funds applications that received exemptive orders in 2019, the average time from the date a fund filed its initial application for exemptive relief to the date the Commission issued the related exemptive order was 127 (378) days and the average number of total filings (*i.e.*, both initial and amended filings) was 1.5 (3).[578] On July 6, 2020, the Commission adopted amendments to establish an expedited review procedure for applications for orders that are substantially identical to recent precedent as well as a rule to establish an internal timeframe for review of applications outside of such expedited procedure. As a result, we expect that future

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578 ETF fund of funds exemptive order applications are typically submitted as part of the applications related to the formation and operation of ETFs, and these unrelated aspects of the applications could bias the cited statistics on the duration and the number of filings of the fund of funds exemptive order process. In addition, the statistics for the processing times and number of filings of ETF fund of funds exemptive order applications are skewed upwards by applications for non-transparent ETFs, which are relatively novel products. When we exclude non-transparent ETF fund of funds applications that received exemptive orders in 2019, the average time from the date a fund filed its initial application for exemptive relief to the date the Commission issued the related exemptive order was 196 days and the average number of filings was 2. There is variation in the duration of the exemptive order process from the date of the initial filing to the date the order is issued. For non-ETF (ETF) fund of funds applications that received exemptive orders in 2019, the duration of the exemptive order process varied from 84 (58) to 155 (2,269) days from the date of the first filing to the date the order was issued, and the number of the filings varied from 1 (1) to 2 (12). Data is retrieved from the Investment Company Act Notices and Orders: Category Listing, *available at* https://www.sec.gov/rules/icreleases.shtml (accessed on July 29, 2020).

delays associated with the application process, including for any funds of funds applications, will decrease significantly following the effective date of these amendments.[579]

Until the Commission grants exemptive relief, fund advisers/sponsors are not permitted to create certain funds of funds and so acquiring funds must forgo certain investments in other funds. In addition, the exemptive order process may lead to uncertainty regarding whether the fund will be able to obtain exemptive relief and regarding the exact terms of the exemptive relief.

As a result of the direct and indirect costs of the exemptive order process, acquiring funds might forgo certain investments in other funds or funds of funds might not be launched in the first place because the fund may conclude that the costs of seeking an exemptive order exceed the anticipated benefits of the investment in another fund beyond the limits of section 12(d)(1).

Funds relying on exemptive orders to develop funds of funds also must comply with the terms and conditions of the exemptive relief. These terms and conditions are designed to prevent the historical abuses that led Congress to enact section 12(d)(1). Existing orders include conditions designed to mitigate the risks of undue influence, duplicative and excessive fees, and overly complex structures.[580]

b. Summary of Relevant Statutory Provisions, Rules, and Industry Practices Associated with Staff No-Action Letters

As an alternative to obtaining an exemptive order, some funds have relied on statutory provisions and rules, and have considered staff-level views expressed in staff no-action letters to structure fund of funds arrangements beyond the limits of section 12(d)(1)(A) and (B). In

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579 The effective date of this rule will be on June 14, 2021. *See* Amendments to Procedures With Respect to Applications Under the Investment Company Act of 1940, Investment Company Act Release No. 33921 (July 6, 2020) [85 FR 57089 (Sept. 15, 2020)].

580 *See supra* section II.C and *infra* section V.C.1.b for detailed discussion of the conditions of the exemptive orders. In addition to the exemptive order conditions, fund investors in management investment companies are protected from potential abusive practices that section 12(d)(1) was designed to prevent as a result of the fiduciary obligations of acquiring and acquired funds' boards of directors and investment advisers.

particular, funds of funds can rely on section 12(d)(1)(G) and rule 12d1-2, section 12(d)(1)(E), and 12(d)(1)(F).[581] In addition, the staff of the Division of Investment Management has issued a line of letters stating that the staff would not recommend enforcement action to the Commission under sections 12(d)(1)(A) or (B) of the Act if a fund acquires the securities of other funds in certain circumstances. We understand that certain industry practices have developed in connection with the staff-level views provided in these letters.[582]

C. Benefits and Costs and Effects on Efficiency, Competition, and Capital Formation

Where possible, we have attempted to quantify the costs, benefits, and effects on efficiency, competition, and capital formation expected to result from the final rule. In some cases, however, we are unable to quantify the economic effects because we lack the information necessary and commenters have not made data available to provide a reasonable estimate. For example, we are unable to estimate the number of new funds of funds that potentially will be created as a result of the adoption of the final rule, because we do not have information about the extent to which the exemptive order application process and the conditions associated with exemptive relief limit the creation of funds of funds. Further, we do not have information needed to estimate likely changes in investor demand for funds of funds following the adoption of the final rule. In those circumstances, in which we do not have the requisite data to assess the impact of the final rule quantitatively, we have qualitatively analyzed the economic impact of the final rule.

1. Benefits and Costs

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581 *See supra* section I.A for detailed discussion of relevant statutory provisions and rules.

582 *See supra* sections II.C.3.d and III for detailed discussion of relevant staff no-action and interpretive letters.

a. General Economic Effects[583]

i. Change in Funds' Investment Flexibility

The final rule will have opposing effects on funds' investment flexibility. On one hand, rule 12d1-4 will expand funds' investment flexibility by expanding the scope of permissible acquiring and acquired funds relative to the current exemptive orders.[584] In particular, our current exemptive orders permit registered funds to invest only in certain other funds beyond the limits of section 12(d)(1), but rule 12d1-4 will expand the scope of permissible acquired funds by permitting both registered funds and BDCs to invest in all other registered funds and BDCs beyond the limits of section 12(d)(1) subject to certain conditions. Hence, relative to current exemptive orders, rule 12d1-4 will additionally allow (i) open-end funds to invest in unlisted BDCs and registered closed-end funds; (ii) UITs to invest in unlisted closed-end funds and listed and unlisted BDCs; (iii) closed-end funds to invest in open-end funds, UITs, and listed and unlisted BDCs and registered closed-end funds; (iv) BDCs to invest in open-end funds, UITs, ETMFs, and listed and unlisted BDCs and registered closed-end funds; and (v) ETFs to invest in ETMFs and unlisted BDCs and registered closed-end funds. By expanding the scope of permissible acquiring and acquired funds, rule 12d1-4 will enhance acquiring funds' investment flexibility and will increase acquired funds' access to financing.[585]

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583 *See supra* footnote 532 for a discussion of the economic effects of the N-CEN reporting requirements.

584 *See*, *e.g.*, ICI Comment Letter for similar arguments.

585 A commenter argued that by expanding the scope of permissible acquiring and acquired funds, rule 12d1-4 will encourage the creation of funds of funds that "expose investors to excessive costs and poor performance and other risks associated with overly complex structures" and "the Commission has proposed this expansion without any serious analysis of what would result from such a sweeping change or explanation of why it would be in investors' best interest." *See* CFA Comment Letter. *See supra* section II.A.1 for discussion of this comment letter, including a discussion of why we believe the conditions of rule 12d1-4 will address the concerns raised.

In addition, rule 12d1-4 will expand funds' investment flexibility and, more specifically, their ability to create multi-tier structures in the following way. Our current exemptive orders provide an exception from the three-tier limitation for investments in funds that are wholly-owned and controlled by the acquired fund as long as the investment adviser to the acquired fund is also the investment adviser to the wholly-owned subsidiary, while rule 12d1-4 does not include the requirement that the acquired fund and the wholly-owned subsidiary share the same investment adviser.

Finally, an existing staff no-action letter considers acquired fund investments of up to 10% of its assets in other funds, including "central funds," subject to certain conditions, including a condition that the acquired fund would not exceed the 5% limit in section 12(d)(1)(A)(ii) with respect to an investment in shares of a single central fund.[586] In contrast, rule 12d1-4 will permit an acquired fund to invest up to 10% of its assets in other funds, regardless of the size of the investment in any one fund, the affiliation with the acquired fund, or the purpose of the investment. Hence, rule 12d1-4 will expand funds' investment flexibility relative to the baseline by (i) permitting acquired funds' investments in both affiliated and unaffiliated funds (*i.e.*, compared to the no-action letter, which only regards acquired fund investments in affiliated funds); and (ii) not imposing the 5% limit on investments in any single fund.

On the other hand, the conditions of rule 12d1-4, the rescission of rule 12d1-2, and the withdrawal of certain staff letters[587] will decrease certain funds' investment flexibility by restricting their ability to create certain multi-tier structures, and thus may require certain

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586 *See* Franklin Templeton No-Action Letter, *supra* footnote 421. Central funds are affiliated funds commonly created by an adviser for the purpose of efficiently managing exposure to a specific asset class.

587 *See supra* section III.

acquiring funds to change their investments in acquired funds over time compared to the baseline.[588] In particular, our current exemptive orders prohibit an acquired fund from investing in other funds beyond the limits in section 12(d)(1), but they do not expressly prohibit a fund from investing in an acquiring fund beyond the limits of section 12(d)(1). In addition, section 12(d)(1)(G) requires an acquired fund to have a policy that prohibits it from acquiring any securities of a registered open-end fund or UIT in reliance on section 12(d)(1)(G) or (F), but section 12(d)(1)(G) does not require the acquired fund to have a policy that prohibits it from acquiring the securities of a fund in excess of the limits in section 12(d)(1)(A) in reliance on an exemptive order issued by the Commission.[589]

Further, our exemptive orders permit acquired funds to invest in other funds beyond the statutory limits for short-term cash management purposes.[590] Some of these orders have allowed an acquired fund to invest in short-term bond funds for these purposes.[591] Rule 12d1-4 will permit acquired funds to invest in funds in reliance on rule 12d1-1 beyond the statutory limits,

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588 *See*, *e.g.*, SBIA Comment Letter; ICI Comment Letter; DPW Comment Letter; PIMCO Comment Letter; Fidelity Comment Letter; Guggenheim Comment Letter; TRP Comment Letter; Dechert Comment Letter; MFS Comment Letter; PGIM Comment Letter; Ropes Comment Letter; SIFMA AMG Comment Letter; ABA Comment Letter; Fidelity Fixed Income Trustees Comment Letter for related discussion that rule 12d1-4, the rescission of rule 12d1-2 and certain exemptive orders, and the withdrawal of certain staff no-action letters as proposed may limit funds' ability to structure certain multi-tier fund of funds arrangements that are currently permissible.

589 Our analysis shows 73 three-tier structures for which the top-tier acquiring fund is a 12(d)(1)(G) fund and the second-tier acquired fund invests in the third tier beyond the 12(d)(1)(A) limits. *See supra* footnote 545 for methodology used to identify 12(d)(1)(G) funds. The results of this analysis should be interpreted with caution because our data does not allow us to distinguish whether the second-tier acquired fund invests in the third tier beyond the 12(d)(1)(A) limits in reliance on exemptive orders.

590 *See*, *e.g.*, Federated Investment Management Company, Investment Company Act Release Nos. 30093 (June 1, 2012) [77 FR 34095 (June 8, 2012)] (notice) and 30123 (Jun. 26, 2012) (order); Diamond Hill Capital Management, Inc., et al., Investment Company Act Release Nos. 31433 (Jan. 28, 2015) [80 FR 5825 (Feb. 3, 2015)] (notice) and 31472 (Feb. 24, 2015) (order).

591 *See supra* footnote 590. Relatedly, the staff stated in the Thrivent No-Action letter that it would not recommend enforcement action if an acquired fund invested, solely for short-term cash management purposes, up to 25% of its assets in a central fund that is a fixed-income fund that could have a dollar-weighted average portfolio maturity of up to 3 years. *See supra* footnote 423.

regardless of the purpose of the investment.[592] This condition of rule 12d1-4 will increase funds' investment flexibility to create multi-tier structures to the extent that acquired funds invest in funds in reliance on rule 12d1-1 above the statutory limits for purposes other than cash management. An acquired fund could also invest up to 10% of its assets in short-term bond funds pursuant to the 10% Bucket.[593] However, this condition of rule 12d1-4 will decrease funds' flexibility to create multi-tier structures relative to existing exemptive orders to the extent an acquired fund may no longer rely on a cash management exception to invest in excess of the statutory limits in short-term bond funds.[594] Accordingly, on balance, the rule preserves substantial flexibility for acquired funds to invest in underlying funds for cash management purposes with an exception for investments in underlying funds pursuant to rule 12d1-1 and a separate 10% Bucket for investments in underlying funds that do not comply with the terms of rule 12d1-1.

Our analysis shows 23 multi-tier structures in which at least one acquiring fund in each level invests in at least one acquired fund beyond the section 12(d)(1) limits, and thus may be affected by the final rule.[595] Nevertheless, our analysis of multi-tier structures should be interpreted with caution because we lack data that would allow us to identify whether existing

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592 *See* rule 12d1-4(b)(3)(ii)(B).

593 An acquired fund may wish to invest in money market funds, short-term bond funds, or other cash management funds for various portfolio management purposes, including for cash management, liquidity management, to seek a higher level of return on investments used to collateralize derivatives (or other) positions, and to achieve greater diversification and trading efficiency. *See* Guggenheim Comment Letter.

594 As a result of this restriction in funds' investment flexibility, acquired funds may (i) invest more in money market funds instead of short-term bond funds, which may reduce fund returns; (ii) invest in funds that charge separate advisory fees or cease to waive their own fees, potentially resulting in higher costs for fund investors; and/or (iii) make direct investments in short-term bonds, which may increase transaction costs and decrease those funds' ability to diversify. The remaining enumerated exceptions to the complex rule condition of rule 12d1-4 (*i.e.*, rule 12d1-4(b)(3)(ii)(A)–(E)) are similar to the conditions in our exemptive orders and thus likely will not materially affect funds' ability to create multi-tier structures.

595 *See supra* footnote 551.

multi-tier structures that were created under the complex structures conditions in our exemptive orders or in consideration of the existing no-action letters will comply with the conditions of rule 12d1-4. Further, like the limits under section 12(d)(1) of the Act, the complex structures investment prohibitions of rule 12d1-4 are applicable at acquisition. Accordingly, only funds that seek to increase their investments in other funds beyond the statutory limits will be limited by the rule's complex structures prohibitions.[596]

Several commenters argued that the rescission of rule 12d1-2 will decrease the investment flexibility of funds that currently rely on section 12(d)(1)(G) and rule 12d1-2 to structure affiliated fund of funds arrangements.[597] Funds that currently rely on section 12(d)(1)(G) and rule 12d1-2 can now rely on rule 12d1-4 to structure the same arrangements instead. In particular, rule 12d1-4, unlike section 12(d)(1)(G), does not limit acquiring funds' ability to invest in securities other than securities issued by affiliated funds. Thus, a fund that wishes to invest in affiliated funds beyond the limits of section 12(d)(1) can also invest in (i) unaffiliated fund securities up to the limits in section 12(d)(1)(A) or (F); (ii) securities of money market funds in reliance on rule 12d1-1; and (iii) stocks, bonds, and other securities subject to the conditions of rule 12d1-4, rather than section 12(d)(1)(G) and rule 12d1-2. The funds that will choose to operate in accordance with rule 12d1-4, however, will need to comply with the rule's conditions and incur the costs associated with these conditions.[598] In addition, we believe

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596 *See supra* footnote 416.

597 *See*, *e.g.*, Allianz Comment Letter; PIMCO Comment Letter; Thrivent Comment Letter; Hancock Comment Letter; Fidelity Comment Letter; NYC Bar Comment Letter; Nuveen Comment Letter; Chapman Comment Letter; Russell Comment Letter; SIFMA AMG Comment Letter; ABA Comment Letter; Fidelity Fixed Income Trustees Comment Letter.

598 *See infra* section V.C.1.b for detailed discussion of the costs and benefits associated with the conditions of rule 12d1-4. Funds that currently rely on section 12(d)(1)(G) and rule 12d1-2 will only be required to restructure their portfolio if they choose to continue relying on section 12(d)(1)(G) to avoid compliance with the conditions of rule 12d1-4. *See*, *e.g.*, Allianz Comment Letter (stating that funds "may be compelled to restructure to avoid the most challenging aspects of the Proposal.").

that many of the commenter concerns related to potential changes in funds' investment flexibility as a result of the rescission of rule 12d1-2 will be alleviated because we are not adopting the proposed redemption limit.

The final rule will require some existing funds of funds to change their portfolios to ensure compliance with the final rule, and these portfolio changes may impose the following costs on acquiring funds: (i) legal and transaction costs to restructure their portfolios; (ii) sale of the shares of acquired funds at potentially depressed prices; (iii) tax implications, which will depend on whether the acquiring fund will sell shares of acquired funds at a gain or a loss; (iv) disruption in the acquiring funds' investment strategy; and (v) disclosure costs to the extent that funds will change their investment strategy.[599] The prohibition of certain multi-tier structures may also result in less efficient fund of funds structures (*i.e.*, funds of funds with fewer investment options, higher administrative costs, higher transaction costs, and/or lower returns) to the detriment of acquiring fund investors.[600]

The final rule will also impose costs on acquired funds that will lose the investments of the acquiring funds in them. As a result, acquired funds may be unable to achieve economies of scale in portfolio management, resulting in decreased efficiencies and increased operating costs for acquired fund shareholders. Acquired funds will also bear costs associated with selling assets in their portfolios to meet any redemptions by acquiring funds, assuming that acquiring fund

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599 We do not quantify these costs because we lack data that would allow us to provide meaningful estimates of the costs and commenters did not provide any relevant data. Some additional difficulties with quantification are: (i) the magnitude of certain costs depends on market conditions and market conditions are unpredictable (*e.g.*, sale of shares at depressed prices); (ii) certain costs are inherently difficult to quantify because they are not well defined (*e.g.*, disruption in the acquiring funds investment strategy); and (iii) funds have some discretion as to whether and when they will incur the costs associated with the restructuring of their portfolios (*i.e.*, the rule imposes an acquisition test) and so it is difficult to predict the magnitude of the costs associated with restructuring.

600 *See*, *e.g.*, PIMCO Comment Letter; ABA Comment Letter for similar arguments.

redemptions are not made in kind. Finally, certain funds may opt for more complex, costly, and unregulated structures to avoid the rule 12d1-4 conditions.[601] For example, some funds may opt to invest directly in multiple securities, rather than investing in other funds that hold such securities, which may increase the funds' complexity and cost of operations. Nevertheless, we believe that any such costs to funds and their investors will be moderated by benefits associated with improved investor protection, and a more efficient regulatory framework for funds of funds, under the final rule.[602]

ii. Eliminate the Need to Apply for an Exemptive Order

Rule 12d1-4 will permit prospective acquiring funds to acquire the securities of other funds beyond the limits of section 12(d)(1)(A) of the Act and will permit prospective acquired funds to sell their shares to acquiring funds beyond the limits of section 12(d)(1)(B) of the Act without the expense and delay of obtaining an exemptive order, subject to certain conditions.[603] Assuming that the number of exemptive orders granted by the Commission would stay the same absent the final rule, we estimate that by removing the need to obtain an exemptive order, the final rule will eliminate annual aggregate administrative costs to prospective acquiring and acquired funds of approximately $4.2 million relative to the baseline.[604] Any cost savings to

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601 *See*, *e.g.*, Hancock Comment Letter (noting that "[S]ome of these structures may be unregulated or may be more complex or have higher costs. For example, we believe that some investment managers may elect to rely more heavily upon unregistered products or may use multiple portfolio sleeves within a single registered fund, which could potentially introduce additional costs and administrative complexities").

602 For example, rule 12d1-4 will impose the undue influence finding requirement on both affiliated and unaffiliated funds, which may enhance investor protection. *See infra* sections V.C.1.b and V.C.2.i for detailed discussion of the effects of the final rule on regulatory efficiency and investor protection.

603 Existing funds of funds that currently rely on exemptive orders that provide relief similar to rule 12d1-4 have already incurred the cost of the exemptive order process. Hence, these funds will not benefit from eliminating the need to apply for an exemptive order under rule 12d1-4.

604 In 2019, the Commission granted 4 non-ETF fund of funds orders and 38 ETF fund of funds orders (*see supra* footnote 578 for the source of the exemptive order data). Hence, the final rule could result in annual aggregate administrative cost savings to funds of funds equal to $4,200,000, *i.e.*, $4,200,000 = (4 non-ETF

prospective acquiring and acquired funds derived from eliminating the need to apply for an exemptive order likely will be more pronounced for smaller funds or smaller fund complexes because (i) the administrative cost of the exemptive order application process likely does not vary with fund size, and thus may constitute a higher percentage of a smaller fund's assets; and (ii) the same exemptive order can be used by multiple funds within a fund complex, and there may be fewer funds to benefit from an exemptive order within smaller fund complexes.[605]

Rule 12d1-4 also will remove the delay incurred by funds and their sponsors when applying for an exemptive order. As mentioned above, the average time it took a non-ETF (ETF) fund to obtain exemptive relief in 2019 was 127 (378) days.[606] If funds are not required to apply for an exemptive order, prospective acquiring funds will not be required to forgo investments in other funds while awaiting exemptive relief, which ultimately will permit these funds to achieve an efficient allocation of fund assets sooner and will permit these funds to better time their investments in other funds (*i.e.*, potentially purchase shares at more favorable prices). Further, by removing the delay associated with the exemptive order process, prospective acquiring funds will be able to bring new products to the market faster, which will expand investors' investment opportunities and may therefore foster capital formation.[607] Prospective acquired funds also will benefit because the acquiring funds' investments in them will increase

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fund of funds orders + 38 ETF fund of funds orders) x $100,000 administrative cost per exemptive order. The cost savings associated with removing the need to apply for exemptive relief for ETF fund of funds arrangements as discussed here are separate from the cost savings associated with removing the need to apply for exemptive relief for ETFs as discussed in the ETF adopting release. *See* 2019 ETF Adopting Release, *supra* footnote 25, at 57207. The direct administrative costs associated with the need to apply for an exemptive order are one-time costs and each exemptive order can be used by multiple funds within the same fund complex.

605 *See*, *e.g.*, MFDF Comment Letter for a similar argument.

606 *See supra* footnote 578 for the source of the exemptive order data.

607 *See infra* section V.C.2.iii for detailed discussion of the effect of the final rule on capital formation.

their assets more quickly, and as a result the acquired funds may achieve economies of scale more quickly, ultimately benefitting the existing and future shareholders of the acquired funds, which may also foster capital formation.[608]

Rule 12d1-4 also will remove the uncertainty associated with the exemptive order process.[609] Uncertainty related to the exemptive order process may negatively affect fund investment decisions, thus potentially suppressing fund investment and growth.[610] Nevertheless, the effects of the final rule on uncertainty likely will be limited by the fact that the terms of exemptive relief for funds of funds have become to a large extent standardized and the approval of applications for exemptive relief has become somewhat routine.

Investors may benefit from these direct and indirect cost reductions. For example, prospective fund advisers, sponsors, and other service providers may pass cost savings associated with no longer having to request exemptive relief through to investors by lowering fees and expenses. The degree of potential reduction of fund fees and expenses depends on the level of competition in the fund industry. To the extent that the fund industry is competitive, we believe that fund advisers, sponsors, and other service providers will pass on to investors a higher percentage of cost savings arising from the final rule. Conversely, if the level of competition is low, fund advisers, sponsors, and other service providers will retain a higher percentage of cost savings arising from the final rule rather than passing these cost savings on to investors.

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608 *See supra* footnote 607.

609 *See supra* section V.B.2.a for detailed discussion of costs associated with the exemptive order process.

610 Academic literature provides evidence consistent with the idea that uncertainty has negative effects on investment and growth. *See*, *e.g.*, Nicholas Bloom, Stephen Bond, & John Van Reenen, *Uncertainty and Investment Dynamics*, 74 REV. ECON. STUD. 391 (2007); Nicholas Bloom, *The Impact of Uncertainty Shocks*, 77 ECONOMETRICA 623 (2009); Scott R. Baker, Nicholas Bloom, & Steven J. Davis, *Measuring Economic Policy Uncertainty*, 131 Q. J. ECON. 1593 (2016). The cited studies examine the effect of uncertainty on the economy in general, rather than the effect of uncertainty on funds.

Academic literature provides conflicting evidence regarding the level of competition in the fund industry. On one hand, several papers provide some evidence that the U.S. fund industry is competitive and that greater competition in the fund industry is associated with lower fund fees and expenses.[611] On the other hand, several papers suggest that price competition is not prevalent in the fund industry.[612] We believe there are two potential explanations as to why prior literature provides conflicting evidence on the level of competition in the fund industry. First, prior literature uses different sample periods, focuses on different market segments, and uses different units of observation (*i.e.*, individual funds versus fund families). Second, it is possible that funds do not compete solely on fees, but instead compete on performance and services.

Further, the cost savings to prospective funds associated with avoiding the exemptive order process under rule 12d1-4 may potentially increase the rate at which new funds of funds become available to investors.[613] The Commission granted 4 non-ETF fund of funds orders and 38 ETF fund of funds orders in 2019.[614] We are unable to estimate the number of new funds of

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611 *See, e.g.*, John C. Coates, IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy* (Harvard John M. Olin Ctr. for L., Econ., and Bus., Discussion Paper No. 592, Aug. 2007); Sunil Wahal & Albert (Yan) Wang, *Competition among Mutual Funds*, 99 J. FIN. ECON. 40 (2011); Ajay Khorana & Henri Servaes, *What Drives Market Share in the Mutual Fund Industry*, 16 REV. FIN. 81 (2012); Burton G. Malkiel, *Asset Management Fees and the Growth of Finance*, J. ECON. PERSP., Spring 2013, at 97. Further, an ICI study suggests that the fund of funds industry is competitive: "Mutual fund expense ratios also have fallen because of economies of scale and competition." *See* 2020 ICI Fact Book, *supra* footnote 4, at 121.

612 *See, e.g.*, John P. Freeman & Steward L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609 (2001) (arguing that there is lack of price competition in the fund industry). *See also* Brad M. Barber, Terrance Odean, & Lu Zheng*, Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows*, 78 J. BUS. 2095 (2005) (finding no relation between fund operating expenses and fund flows); Javier Gil-Bazo & Pablo Ruiz-Verdú, *The Relation between Price and Performance in the Mutual Fund Industry*, 64 J. FIN. 2153 (2009) (showing that funds with worse before-fee performance charge higher fees).

613 We expect that the effect of the final rule on the number of acquiring BDCs will be limited because BDCs are prohibited from making any investment unless, at the time of the investment, at least 70% of the BDC's total assets are invested in securities of certain specific types of companies, which do not include funds (*see supra* footnote 39).

614 *See supra* footnote 604.

funds that will be created following the adoption of the final rule, but we believe that the number of new funds of funds will be higher than the number of funds of funds that were created as a result of the exemptive orders granted in 2019 because the final rule permits the establishment of funds of funds without the cost of the exemptive order process.

Academic research suggests that investment decisions are sensitive to the number of available investment opportunities.[615] Hence, investor demand for funds of funds may increase as a result of the increased number of funds of funds under the final rule. In particular, investors may increase their investments in funds of funds by either decreasing their investments in other asset classes or increasing their investment rate. More specifically, as an alternative to investing in funds of funds, investors may meet their investment objectives by assembling a portfolio of funds through non-discretionary or discretionary separate accounts with a broker/dealer or investment adviser or by investing directly in funds without the intermediation of broker/dealers or investment advisers. Nevertheless, funds of funds may represent an efficient alternative to such a strategy because fund of funds investors can avoid minimum investment requirements, invest in funds that have been closed to new investors, invest in funds that are restricted to a particular investor type, avoid certain transaction costs, and enjoy lower recordkeeping and monitoring costs relative to investors that directly invest in multiple funds.[616] As a result, the

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615 *See* Shlomo Benartzi & Richard H. Thaler, *Naive Diversification Strategies in Defined Contribution Saving Plans*, AM. ECON. REV., Mar. 2001, at 79 (presenting survey evidence and plan-level statistics that support the idea that retirement plan investors practice "1/n" diversification across all available investment alternatives). *But see* Gur Huberman & Wei Jiang, *Offering versus Choice in 401(k) Plans: Equity Exposure and Number of Funds*, 61 J. FIN. 763 (2006) (demonstrating that individual-level analysis of 401(k) plan data yields different results from plan-level analysis, showing that individuals are less sensitive to the overall number of investment alternatives, but may practice "1/n" within a smaller subset of alternative investments).

616 *See, e.g.*, Edwin J. Elton et al., *Target Date Funds: Characteristics and Performance*, 5 REV. ASSET PRICING STUD. 254 (2015) (showing that "additional expenses charged by TDFs are largely offset by the low-cost share classes they hold, not normally open to their investors.").

entry of new funds of funds that do not replicate existing investment opportunities may increase investor demand for funds of funds because those funds will provide investors the opportunity to obtain diversified exposure to different asset classes through a single, professionally managed portfolio at a potentially lower cost compared to investing in a portfolio of funds through discretionary or non-discretionary separate accounts.

iii. Assess Compliance with the Final Rule

Existing acquired and acquiring funds relying on exemptive orders on which rule 12d1-4 is based will incur a one-time administrative cost to assess whether their operations are consistent with rule 12d1-4 by examining differences between the exemptive order conditions they are currently required to meet and the conditions of rule 12d1-4. Further, existing acquiring funds currently relying on section 12(d)(1)(G) and rule 12d1-2 to structure funds of funds will be required to decide whether to continue relying on section 12(d)(1)(G) and amended rule 12d1-1 or instead operate in accordance with rule 12d1-4 and comply with the rule's conditions. We believe this assessment will result in a one-time cost equal to $3,315 per fund and an aggregate one-time cost of $7.6 million for all affected funds.[617]

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617 We estimate that assessing the requirements of rule 12d1-4 will require 5 hours of a compliance manager ($304 per hour) and 5 hours of a compliance attorney ($359 per hour), resulting in a cost of $3,315 (= 5 hours x $304 + 5 hours x $359) per fund. The Commission's estimates of the relevant wage rates in the tables below are based on salary information for the securities industry compiled by the Securities Industry and Financial Markets Association's Office Salaries in the Securities Industry 2013. The estimated wage figures are modified by Commission staff to account for an 1,800-hour work-year and inflation, and multiplied by 5.35 to account for bonuses, firm size, employee benefits, overhead, and adjusted to account for the effects of inflation. *See* Securities Industry and Financial Markets Association, Report on Management & Professional Earnings in the Securities Industry 2013 ("SIFMA Report") for the source of salary data. The total cost for the 1,211 acquiring and 1,069 acquired funds that will be subject to rule 12d1-4 will thus be $7.6 million. $7.6 million = (1,211 acquiring funds that may be required to assess compliance with the rule + 1,069 acquired funds that may be required to assess compliance with the rule) x $3,315 one-time costs to assess compliance with the final rule per fund. Our estimate is likely an upper bound of the cost associated with assessing compliance with the final rule because we count separately the cost for acquiring and acquired funds but certain acquiring funds may also be acquired funds that will be subject to the final rule, and vice versa, and there may be synergies to assess compliance with the final rule for those funds. 1,211 acquiring funds that will be subject to rule 12d1-4 = [1,719 acquiring registered

b. Effects of New and Omitted Conditions

Rule 12d1-4 will include new conditions relative to the conditions in our current exemptive orders and rule 12d1-2, and will omit certain conditions contained in our exemptive orders that are not necessary in light of the new conditions of rule 12d1-4. The new conditions of rule 12d1-4 are designed to limit the acquiring funds' undue influence over the acquired funds, limit duplicative fees for acquiring fund investors, limit the creation of complex fund structures, and ultimately encourage effective oversight of fund of funds structures. The rule 12d1-4 conditions augment certain conditions in our exemptive orders, which will likely enhance investor protections. We expect, however, that the implementation and monitoring of these new conditions will impose certain incremental one-time and ongoing costs on funds and their investors.[618] We discuss the benefits and costs of each of the new conditions of rule 12d1-4 and the conditions of existing exemptive orders that rule 12d1-4 omits in detail below.[619]

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investment companies that invest in other funds beyond the section 12(d)(1) limits (*see* Table 1 in *supra* section V.B.1) + 37 acquiring BDCs (*see supra* footnotes 558 and 559 and associated text)] x 69% of acquiring funds that invest in other funds beyond the section 12(d)(1) limits and will be subject to rule 12d1-4 as estimated by a commenter (*see supra* footnote 537 and associated text). Our calculation assumes that the commenter's sample is representative of the acquiring funds in Table 1. 1,069 acquired funds that will be subject to rule 12d1-4 = [3,392 acquired registered investment companies that have a non-zero investment from other funds (*see* Table 2 in *supra* section V.B.1) + 50 acquired BDCs (*see supra* footnotes 558 and 559 and associated text)] x 45% of acquired funds for which there is at least one acquiring fund that invests in them beyond the 3% limit of section 12(d)(1) x 69% of acquired funds that have investments from other funds in them beyond the 3% limit of section 12(d)(1) and will be subject to rule 12d1-4 as estimated by a commenter (*see supra* footnote 537 and associated text). Our calculation assumes that the commenter's estimate of acquiring funds that will be subject to rule 12d1-4 is also applicable to acquired funds.

618 *See also* Guggenheim Comment Letter (noting that the conditions of rule 12d1-4 will "likely result in significant additional compliance, investment and practical costs and burdens that ultimately may result in increased fund expenses. We note that the proposed conditions would necessitate meaningful investments in technology, personnel, training and other compliance-related resources to monitor holdings of acquired funds, particularly when such 'advisory groups' involve large diversified financial services institutions."). Some of the costs discussed by the commenter may be no longer relevant given the changes in the rule's conditions relative to the 2018 FOF Proposing Release.

619 *See supra* section II.C for discussion of the rule's conditions. In this section, we compare the conditions of rule 12d1-4 to the conditions of our current exemptive orders. Hence, the discussion in this section describes the effects of rule 12d1-4 on (i) funds that currently rely on our exemptive orders to invest in

i. Undue Influence – Control

Rule 12d1-4 mandates that the acquiring fund and its advisory group will not control (individually or in the aggregate) an acquired fund. Control is presumed when a fund owns more than 25% of the voting securities of another fund. The control condition does not apply to affiliated fund of funds structures. The control condition of rule 12d1-4 is consistent with the conditions of our current exemptive orders and thus will not have an economic effect relative to the baseline.[620]

ii. Undue Influence – Voting conditions

Rule 12d1-4 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): (i) hold more than 25% of the outstanding voting securities of an acquired open-end fund or UIT due to a decrease in the outstanding securities of the acquired fund; or (ii) hold more than 10% of the outstanding voting securities of an acquired closed-end fund or BDC.[621]

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other funds beyond the limits of section 12(d)(1) but will be subject to rule 12d1-4 following the rescission of our exemptive orders; and (ii) funds that would otherwise choose to rely on our exemptive orders in the future to invest in other funds beyond the limits of section 12(d)(1) but will be subject to rule 12d1-4 following the final rule adoption. Any effects discussed in this section will be more pronounced for funds that currently rely on section 12(d)(1)(G) and rule 12d1-2 to invest in affiliated funds beyond the limits of section 12(d)(1) but will be subject to rule 12d1-4 following the final rule adoption, because the conditions of section 12(d)(1)(G) and rule 12d1-2 are less costly than the conditions in our current exemptive orders. In particular, in contrast to our exemptive orders, funds relying on section 12(d)(1)(G) and rule 12d1-2 to invest in affiliated funds beyond the limits of section 12(d)(1) are not required to enter into a participation agreement or make certain findings and adopt procedures to prevent overreaching and undue influence by the acquiring fund and its affiliates. Further, the conditions aimed at mitigating excessive and duplicative fees under section 12(d)(1)(G) are more limited in scope than the fee conditions in our exemptive orders. *See*, *e.g.*, Invesco Comment Letter for a discussion of compliance burdens associated with the rescission of rule 12d1-2 and the potential reliance of affiliated funds of funds on rule 12d1-4 instead of section 12(d)(1)(G) and rule 12d1-2.

620 Commenters agreed with the assertion that the control condition of rule 12d1-4 is consistent with the conditions of the existing orders. *See*, *e.g.*, ICI Comment Letter. A commenter argued that "many advisers already have systems in place to monitor holdings at the 'advisory group level,'" which would decrease any potential compliance costs associated with this aspect of the final rule. *See* Invesco Comment Letter.

621 The voting condition of rule 12d1-4 is not applicable when an acquiring fund is within the same group of investment companies as an acquired fund or the acquiring fund's investment sub-adviser or any person

Acquired open-end funds and UITs. Our current exemptive orders require an acquiring fund and its advisory group to vote their shares of an acquired open-end fund or UIT using mirror voting only if the acquiring fund and its advisory group hold more than 25% of the acquired fund's outstanding voting securities due to a decrease in the outstanding securities of the acquired fund. Hence, for acquiring funds that hold shares of open-end funds or UITs beyond the section 12(d)(1) limits, the voting condition of rule 12d1-4 is the same as the voting condition in our exemptive orders, and so we expect that this aspect of the rule will not impose additional costs on funds relative to the exemptive orders.

Acquired BDCs and registered closed-end funds. Rule 12d1-4 differs from our current exemptive orders for acquiring funds that invest in acquired registered closed-end funds or BDCs beyond the limits of section 12(d)(1) because (i) it imposes a 10% (instead of 3% in the exemptive orders) voting threshold; and (ii) it only allows mirror voting (instead of either mirror or pass-through voting in the exemptive orders) for all funds within the acquiring funds' advisory group.[622] Hence, rule 12d1-4 is less restrictive than our current exemptive orders in terms of the voting threshold but more restrictive than our current exemptive orders in terms of permissible voting methods for acquiring funds that invest in acquired BDCs and registered closed-end funds.

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controlling, controlled by, or under common control with such investment sub-adviser acts as the acquired fund's investment adviser or depositor. *See* rule 12d1-4(b)(1)(iii). In circumstances where all holders of the outstanding voting securities of the acquired fund are required by rule 12d1-4 or otherwise under section 12(d)(1) to mirror vote the securities of the acquired fund, the acquiring fund may use pass-through instead of mirror voting. *See* rule 12d1-4(b)(1)(ii). Our exemptive orders do not include such a condition. Our analysis shows no existing acquired funds that will be subject to this rule condition (*i.e.*, acquired funds that are only held by acquiring funds that are subject to the voting conditions of rule 12d1-4). Hence, we expect that the economic effects of this aspect of the rule will be immaterial.

[622] Similar to the rule's voting condition, our current exemptive orders require non-fund entities within the advisory group to use mirror voting.

The voting conditions of rule 12d1-4 with respect to acquired BDCs and registered closed-end funds may have the following costs. First, we estimate that all acquiring funds that invest in registered closed-end funds or BDCs in reliance on rule 12d1-4 will incur a one-time cost to update their proxy voting policies to reflect that the fund is potentially subject to the voting provisions of the rule. Our analysis shows that only one of the existing acquiring funds invests in at least one registered closed-end fund beyond the 10% voting threshold.[623] Hence, for funds that invest in registered closed-end funds or BDCs in reliance on rule 12d1-4, we expect that the one-time cost to update their proxy voting policies will be immaterial. Nevertheless, we estimate that the one-time cost for acquiring funds that invest in BDCs and registered closed-end funds beyond the 10% voting threshold to update their proxy voting policies will be equal to $1,257 per fund.[624]

Second, the cost of the more restrictive voting methods (*i.e.*, the rule generally permits only mirror voting) of rule 12d1-4 relative to our current exemptive orders is that the rule may increase economic distortions in the voting process since mirror voting requires the acquiring fund to vote in the same proportion as the vote of all other holders of the acquired fund shares.[625] The economic effect of any distortions in the voting process is unclear and will depend on: (i) the percentage of acquired fund shares that are held by non-fund shareholders and funds that are not subject to the voting conditions; (ii) the composition of the acquiring fund shareholders (*e.g.*,

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[623] Results are the same when aggregating fund holdings across funds sharing the same adviser or sub-adviser. We lack structured data on BDCs' outstanding shares and so BDCs are excluded from this analysis. Our data does not allow us to identify whether acquiring funds hold voting or non-voting securities of the acquired funds, which may result in misestimation of the number of acquiring funds that hold an investment in at least one closed-end fund or BDC beyond the 10% voting threshold. This data limitation applies to all analysis in section V that uses voting share information.

[624] *See* Table 5 in *infra* section VI.B.1.

[625] *See*, *e.g.*, ICI Comment Letter; Nuveen Comment Letter; Schwab Comment Letter; TPG Comment Letter; SIFMA AMG Comment Letter noting that both pass-through and mirror voting can introduce distortions in the shareholder voting process, but those distortions are more pronounced in the case of mirror voting.

retail versus institutional investors);[626] and (iii) how frequently votes are close and so the acquiring fund's voting may determine the outcome of the vote.

Relatedly, the mirror voting requirement applicable to acquiring fund holdings in excess of 10% of an acquired BDC or registered closed-end fund may require advisers to revise existing proxy voting policies and procedures, including those of other members of the advisory group and their respective clients.[627] Additionally, a more restrictive voting method may require an acquiring fund and its advisory group to follow a less flexible proxy voting policy, subject to the other legal requirements that are applicable to an investment adviser's proxy voting responsibilities.[628] However, this effect would be mitigated by the fact that, as discussed below, we believe that the majority of acquiring funds that invest in registered closed-end funds or BDCs beyond the limits of section 12(d)(1) in reliance on our exemptive orders already use mirror voting.

Third, the more restrictive voting methods will impose more voting restrictions on acquiring funds, and thus may decrease funds' incentives to acquire larger blocks of shares (*i.e.*, blocks of shares in excess of the section 12(d)(1) limits but below the 10% threshold of the rule) and thereby potentially support value-increasing actions through their voting.[629]

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626 There are significant differences in voting involvement by institutional investors compared to retail investors (*see*, *e.g.*, Broadridge & PwC, 2019 Proxy Season Review, *available at* https://www.broadridge.com/_assets/pdf/broadridge-proxypulse-2019-review.pdf).

627 *See supra* footnote 161 and associated text for related discussion.

628 *See generally* Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Investment Advisers Act Release No. 5325 (Aug. 21, 2019), at 5-6 [84 FR 47420, 42421 (Sept. 10, 2019)]; id. at 12, Question No. 2 [84 FR 47423]; Supplement to Commission Guidance Regarding Voting Responsibilities of Investment Advisers, Investment Advisers Act Release No. 5547 (July 22, 2020) [85 FR 55155 (September 3, 2020)]. *See also* Exemptions from the Proxy Rules for Proxy Voting Advice, Securities Exchange Act Release No. 89372 (Jul. 22, 2020) [85 FR 55082 (September 3, 2020)] (reaffirming an investment adviser's fiduciary duty to vote in the best interest of its client).

629 Academic literature provides some evidence that shareholder activism has a positive effect on target funds (*see*, *e.g.*, Martin Cherkes, Jacob S. Sagi, & Z. Jay Wang, *Managed Distribution Policies in Closed-End*

The voting conditions of rule 12d1-4 for acquired BDCs and registered closed-end funds may have the following benefits. First, the less restrictive voting threshold of rule 12d1-4 relative to the exemptive orders (*i.e.*, 10% instead of 3%) may decrease economic distortions in the voting process since the voting provision will not apply until an acquiring fund holds a greater percentage of the voting securities of an acquired fund.

Second, the less restrictive voting threshold of rule 12d1-4 relative to the exemptive orders will impose fewer voting restrictions on acquiring funds, and thus may increase funds' incentives to acquire larger blocks of shares and thereby potentially support value-increasing actions through their voting.[630]

Third, assuming no difference between the permissible voting methods under the rule and the exemptive orders, the voting threshold of the rule may decrease ongoing costs associated with voting because it is less restrictive than the voting threshold in existing exemptive orders (*i.e.*, 10% under the rule versus 3% under the exemptive orders). Similarly, holding the voting threshold constant, the more restrictive voting methods of the rule may decrease ongoing costs for funds associated with voting because pass-through voting is more costly to implement than

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Funds and Shareholder Activism, 49 J. FIN. & QUANTITATIVE ANALYSIS 1311 (2014); Michael Bradley et al., *Activist Arbitrage: A Study of Open-Ending Attempts of Closed-End Funds*, 95 J. FIN. ECON. 1 (2010)). Academic literature provides mixed evidence on whether funds are activist investors, *i.e.*, tend to vote with or against the management of the target companies (*see*, *e.g.*, Dragana Cvijanovic, Amil Dasgupta, & Konstantinos E. Zachariadis, *Ties that Bind: How Business Connections Affect Mutual Fund Activism*, 71 J. FIN. 2933 (2006); Rasha Ashraf, Narayanan Jayaraman, & Harley E. Ryan, Jr., *Do Pension-Related Business Ties Influence Mutual Fund Proxy Voting? Evidence from Shareholder Proposals on Executive Compensation*, 47 J. FIN. & QUANTITATIVE ANALYSIS 567 (2012); Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J. FIN. ECON. 552 (2007)). There is some evidence, however, of increased activism by funds, other than hedge funds, over time (*see*, *e.g.*, J.P. Morgan, 2019 Proxy Season Review (Aug. 2019), *available at* https://www.jpmorgan.com/jpmpdf/1320747618625.pdf). The abovementioned studies are not solely focused on acquiring fund activism targeted at acquired funds but also study fund activism targeted at non-funds and non-fund activism targeted at funds.

630 *See supra* footnote 629 and associated text.

mirror voting.[631] Nevertheless, we expect any such cost decreases to be small because we believe that the majority of acquiring funds that invest in registered closed-end funds or BDCs beyond the limits of section 12(d)(1) in reliance on our exemptive orders already use mirror voting, and we expect those funds to continue using mirror voting following the final rule adoption.[632]

Fourth, the additional restriction on voting methods (*i.e.*, only allow mirror voting) may enhance the protection of the acquired fund investors from the acquiring funds' undue influence. Pass-through voting may not provide the same level of protection from acquiring funds' undue influence as mirror voting because acquiring fund investors may vote in line with the recommendations of the acquiring fund investment adviser and board when the acquiring fund uses pass-through voting.[633]

iii. Undue Influence – Findings[634]

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631 *See* Table 5 in *infra* section VI.B.1. Under pass-through voting, acquiring funds must seek voting instructions from their security holders and vote such proxies in accordance with their instructions. Under mirror voting, acquiring funds must vote the acquired fund shares in the same proportion as the vote of all other holders of the acquired fund.

632 Two commenters noted that mirror voting is generally preferable to pass-through voting, and other commenters noted that the expense and logistical challenges associated with pass-through voting make pass-through voting impractical. *See* Invesco Comment Letter (noting that mirror voting is "typically preferable to pass-through voting"); SIFMA AMG Comment Letter (noting that "registered funds would likely mirror vote shares held in any [closed-end funds] subject to the voting condition"). *See also* ICI Comment Letter (noting that "[i]n some situations, the expense and logistical challenges of pass though voting also may be undesirable."); Voya Comment Letter (noting that "the use of pass-through voting would increase the costs and logistical challenges of proxy solicitations…. If these acquiring funds determine to implement pass-through voting, the costs of obtaining approvals of shareholder proposals could increase significantly, without corresponding benefit to [the acquiring] fund's shareholders."); Charles Schwab Comment Letter (noting that "[g]enerally speaking, the expense and logistical challenges make pass-through voting impractical").

633 *See*, *e.g.*, Advent Comment Letter; Comment Letter of Franklin Square Holdings (May 2, 2019) ("Franklin Comment Letter"); Skadden Comment Letter; ABA Comment Letter (arguing that pass-through voting does not provide the same level of protection from undue influence as mirror voting).

634 *See infra* section V.C.1.b.iv for discussion of the condition of rule 12d1-4 related to layering of fees and expenses and complex structures for management companies, UITs, and separate accounts (*i.e.*, rule 12d1-4(b)(2)(i), (ii), and (iii)).

To prevent overreaching and undue influence, current exemptive orders typically require (i) acquired fund boards to make certain findings and adopt procedures at least annually to prevent overreaching and undue influence by the acquiring fund and its affiliates; (ii) acquiring funds to take measures to prevent the acquiring fund from influencing the terms of any services or transactions between the acquiring fund and an unaffiliated acquired fund or causing an unaffiliated acquired fund to purchase a security in any affiliated underwriting; and (iii) acquiring fund boards to adopt procedures reasonably designed to assure that the acquiring fund's investment adviser does not take into account consideration received from an unaffiliated acquired fund. These requirements in the exemptive orders are only applicable to unaffiliated funds of funds and they are only applicable to acquiring and acquired funds that are management companies.

To mitigate concerns of overreaching and undue influence, if an acquired fund is a management company, rule 12d1-4 will require the acquired fund's investment adviser, prior to the initial acquisition of the acquired fund's shares in excess of the limits in section 12(d)(1)(A)(i) of the Act, to find that any undue influence concerns associated with the acquiring fund's investment in the acquired fund are reasonably addressed. As part of this consideration, the acquired fund's investment adviser must consider, at a minimum, the following factors: (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 investments 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 such redemptions in kind. The acquired fund's investment adviser must report its findings and the basis for those findings

to the fund's board of directors no later than the next regularly scheduled board of directors meeting following the acquiring fund's initial investment in the acquired fund.[635]

Hence, rule 12d1-4 will differ from the undue influence conditions in our exemptive orders in the following main ways. First, the undue influence requirement of rule 12d1-4 will only apply to acquired funds, while the policies and procedures requirement in our exemptive orders is applicable to both acquiring and acquired funds.[636] Second, the undue influence requirement of rule 12d1-4 will apply to both affiliated and unaffiliated funds of funds, while the policies and procedures requirement in our exemptive orders only applies to unaffiliated funds of funds. Third, the undue influence requirement of rule 12d1-4 will only apply prior to the initial acquisition of the acquired fund shares, while the policies and procedures requirement for acquired funds in our exemptive orders applies periodically (*i.e.*, at least annually). Fourth, the undue influence requirement of rule 12d1-4 will apply to funds' investment advisers, while the policies and procedures requirement in our exemptive orders applies to funds' boards of directors.

Rule 12d1-4 imposes the undue influence requirement only on acquired funds. The benefit of such an approach is that it will reduce ongoing costs to acquiring funds relative to our exemptive orders because acquiring funds will not be required to adopt policies and procedures to prevent undue influence over the acquired fund. Such an approach, however, may be weaker

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635 Under our exemptive orders, in cases when the investment adviser to the fund assists the board with the findings and procedures to prevent overreaching and undue influence by the acquiring fund and its affiliates, the investment adviser periodically reports its findings to the fund's board of directors. Hence, the reporting requirement in rule 12d1-4 likely is no more burdensome than reporting practices under our exemptive orders.

636 *See* rule 12d1-4(b)(2)(i)(B). Acquiring funds are nevertheless subject to other rule conditions, such as the requirement to enter into a fund of funds investment agreement and the evaluation of the complexity of the structure and findings regarding the aggregate fees and expenses associated with the acquiring fund's investment in the acquired fund.

from an investor protection standpoint to the extent that acquiring funds are no longer required to make findings to prevent undue influence over the acquired fund. We believe that these concerns are mitigated by the rule's additional conditions related to undue influence, including voting requirements, the fund of funds investment agreement requirement, and the fact that the rule will prohibit an acquiring fund and its advisory group from controlling an acquired fund.

Rule 12d1-4 will impose the undue influence requirement on both affiliated and unaffiliated funds of funds, which may enhance investor protection.[637] At the same time, by imposing the undue influence requirement to both affiliated and unaffiliated funds of funds, the undue influence requirement of rule 12d1-4 will be more costly to implement than the policies and procedures in our exemptive orders because a larger number of acquired funds (*i.e.*, both affiliated and unaffiliated funds) will be required to incur the costs associated with the undue influence requirement.[638]

In contrast, by requiring an undue influence finding only at initial acquisition, rule 12d1-4 will reduce costs for acquired funds relative to our exemptive orders because acquired funds

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637 Several commenters stated that affiliated funds of funds do not raise the concerns that section 12(d)(1) was enacted to address. *See*, *e.g.*, PIMCO Comment Letter; Allianz Comment Letter; Thrivent Comment Letter. Academic literature, however, provides results of empirical analysis consistent with the idea that affiliated funds of funds suffer from conflicts of interest. *See*, *e.g.*, Utpal Bhattacharya, Jung H. Lee, & Veronika K. Pool, *Conflicting Family Values in Mutual Fund Families*, 68 J. FIN. 173 (2013); Jung Hoon Lee, *Information Flows in Mutual Fund Families* (Working Paper, Sept. 2014), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2148075. *See also*, *e.g.*, Diane Del Guercio, Egemen Genc, & Hai Tran, *Playing Favorites: Conflicts of Interest in Mutual Fund Management*, 128 J. FIN. ECON. 535 (2018); Jose-Miguel Gaspar, Massimo Massa, & Pedro Matos, *Favoritism in Mutual Fund Families?Evidence on Strategic Cross-Fund Subsidization*, 61 J. FIN. 73 (2006); Luis Goncalves-Pinto, Juan Sotes-Paladino, & Jing Xu, *The Invisible Hand of Internal Markets in Mutual Fund Families*, 89 J. BANKING & FIN. 105 (2018) for evidence consistent with the idea of conflicts of interest in affiliated fund complexes in general (*i.e.*, not necessarily affiliated funds of funds). *See also* CFA Comment Letter for similar arguments. Any such conflicts of interest are, at least partially, mitigated to the extent that the investment adviser owes a fiduciary duty both to the acquiring and acquired funds and the acquiring and acquired funds share the same board of directors that exercise oversight over both funds.

638 *See also* Guggenheim Comment Letter (noting that the finding requirement of rule 12d1-4 will "give rise to the need to incorporate attorneys and accounting staff to assist in documenting the cost of the fund investment and the complexity of the structure prior to making the investment and in preparing a document for review by the board.").

will no longer be required to periodically make findings and adopt procedures related to undue influence. While this rule condition does not require periodic evaluation of acquiring funds' investments in acquired funds, the board may require more frequent subsequent reporting under the fund's compliance program.

Rule 12d1-4 also allocates the responsibility of making undue influence findings to the acquired fund's investment adviser, subject to the board's oversight.[639] As discussed above, our current exemptive orders require the board to approve certain procedures to prevent overreaching and undue influence by the acquiring fund and its affiliates.[640] While rule 12d1-4 does not require the adoption of specific procedures, rule 38a-1 requires funds to adopt written compliance policies and procedures reasonably designed to prevent a violation of the federal securities laws by the fund.[641] Accordingly, we believe that the economic effect of this difference between our exemptive orders and rule 12d1-4 will be limited because funds will be required to maintain similar policies and procedures, and compliance with the exemptive orders is generally facilitated by the fund's investment adviser at the direction of the board.[642] We believe investor protection concerns that had been addressed by the conditions in our exemptive orders will be more effectively addressed by the protective conditions of the final rule, such as

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639 Rule 12d1-4(b)(2).

640 For example, our orders require an unaffiliated acquired fund board to adopt procedures reasonably designed to monitor purchases by the unaffiliated acquired fund in an underwriting in which an affiliate of the acquiring fund is the principal underwriter. In addition, the acquiring fund's board of directors, including a majority of its independent directors, is required by our orders to adopt procedures reasonably designed to assure that the acquiring fund's investment adviser does not take into account consideration received from an unaffiliated acquired fund (or certain of the unaffiliated acquired fund's affiliates).

641 *See supra* footnote 59 and associated text.

642 Some commenters argued that allocating more responsibilities to the fund's investment adviser subject to the board's oversight will be beneficial to fund investors because this approach is consistent with the board's current oversight responsibilities. *See* IDC Comment Letter; Hancock Comment Letter; MFDF Comment Letter; ABA Comment Letter.

the requirement that an acquiring fund investment adviser evaluate the complexity of the structure and find that the acquiring fund's fees and expenses do not duplicate the fees and expenses of the acquired fund and that certain funds enter into a fund of funds investment agreement.[643]

The undue influence finding requirement of rule 12d1-4 will impose one-time costs on acquired funds to review the rule's requirement and modify, as necessary, their policies and procedures to comply with the rule, and these costs may be borne by investors in acquired funds.[644] These estimated costs are attributable to the following activities: (i) reviewing the rule's finding requirement; (ii) developing new (or modifying existing) policies and procedures to align with the finding requirement of rule 12d1-4; (iii) integrating and implementing those policies and procedures into the rest of the funds' activities; and (iv) preparing new training materials and administering training sessions for staff in affected areas.

The undue influence requirement of rule 12d1-4 also will impose ongoing costs on an acquired fund's investment adviser each time a new acquiring fund invests in the acquired fund. Our current exemptive orders require fund boards to make certain findings and adopt procedures to prevent overreaching and undue influence by the acquiring fund and its affiliates, and some of those processes and procedures may be similar to the rule's requirements. Consequently, to the extent that investment advisers can leverage some of the existing board processes and procedures

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643 In addition, the acquired fund's board and adviser are subject to ongoing fiduciary obligations and the acquired fund's board must determine an appropriate level of subsequent reporting under the acquired fund's compliance program.

644 Acquired funds will bear the costs associated with rule 12d1-4 only if they permit acquiring fund investments in excess of the section 12(d)(1) limits in reliance on rule 12d1-4 and therefore must comply with the rule's conditions. Acquired funds may be able to pass through some of the costs associated with the rule's conditions to acquiring funds through higher operating expenses. The ability of acquired funds to pass through some of the costs depends on the market power of acquired funds, which ultimately depends on the availability of investment options for acquiring funds.

to comply with the rule's requirements, any ongoing costs will be mitigated. We generally believe that the undue influence finding of rule 12d1-4 is as comprehensive as the policies and procedures in our exemptive orders because both rule 12d1-4 and our exemptive orders allow funds flexibility to determine the undue influence concerns, and to consider factors applicable to those concerns, that may be relevant to each fund of funds structure.[645]

Our staff estimates that the annual costs necessary to comply with the undue influence finding requirement of rule 12d1-4 for acquired management companies will be equal to $45,193 per acquired management company and will result in an aggregate ongoing burden equal to $131 million for all affected acquired management companies.[646]

We expect that the costs associated with the finding requirement of rule 12d1-4 will be incurred by the acquired fund's investment adviser and the acquired fund's board of directors

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645 In particular, rule 12d1-4 requires acquired funds to consider (i) the scale of the acquiring fund's investment in the acquired fund; and (ii) the timing and circumstances of the acquiring fund's redemptions of the acquired fund shares. Our exemptive orders require acquiring funds to consider (i) any services or transactions between the acquiring fund and an unaffiliated acquired fund; (ii) any purchases by the acquired fund of securities in affiliated underwritings; and (iii) any compensation that the acquiring fund investment adviser received from an unaffiliated acquired fund. Rule 12d1-4 requires advisers to consider certain factors at a minimum but does not dictate the particular terms or how advisers must evaluate or weigh the various factors. *See also* Dechert Comment Letter (recommending that the Commission should not set forth specific factors that an adviser should consider when making such a finding).

646 This estimate is based on the following calculation: $131 million = $45,193 initial and annual internal and external burden per fund x 2,900 acquired management companies that will be subject to rule 12d1-4. $45,193 = [$14,994 initial and annual internal burden per fund + $35,220 initial external burden per fund (*see* Table 7 in *infra* section VI.B.3.)] x (1 – 10% of the total burden that is associated with the recordkeeping requirements of rule 12d1-4). This and all subsequent cost estimates in this section that rely on per fund dollar cost estimates from section VI below are an upper bound of the costs imposed by the final rule because they capture the total rather than the incremental cost of the rule's requirements. 2,900 acquired management companies that will be subject to rule 12d1-4 = 4,203 acquired management companies x 69% of acquired management companies that will be subject to rule 12d1-4 as estimated by a commenter (*see supra* footnote 537 and associated text). Our calculation assumes that the commenter's estimate of acquiring funds that will be subject to rule 12d1-4 is also applicable to acquired funds. 4,203 acquired management companies = 3,392 acquired registered investment companies (*see supra* Table 2) x 14,605 registered investment companies (*see* Table 1 in *supra* section V.B.1) / 11,788 management companies (*see* Table 2 in *supra* section V.B.1). This estimate assumes that acquired management companies with investments from acquiring funds beyond the limits of section 12(d)(1) will be subject to rule 12d1-4 at the same rate as the acquired management companies with investments from acquiring funds within the limits of section 12(d)(1) following the rule adoption.

but, depending on market competition and other factors, may partially or fully be borne by the acquired fund shareholders in the form of higher management fees and/or operating expenses.

iv. Layering of Fees and Expenses

Our current exemptive orders contain a set of conditions designed to prevent duplicative and excessive fees and expenses in fund of funds structures. In particular, for management companies, our exemptive orders: (i) limit sales charges and service fees charged by the acquiring fund to those set forth in the FINRA's sales charge rule; (ii) require an acquiring fund's adviser to waive fees otherwise payable to it by the acquiring fund in an amount at least equal to any compensation received from an acquired fund that is not part of the same group of investment companies by the adviser, or an affiliated person of the adviser, other than advisory fees paid to the adviser or its affiliated person by such an acquired fund, in connection with the investment by the acquiring fund in such acquired fund; and (iii) require the acquiring fund board to find that advisory fees are based on services provided that are in addition to, rather than duplicative of, the services provided by an adviser to an acquired fund. For UITs, our exemptive orders: (i) limit sales charges and service fees charged by the acquiring fund to those set forth in FINRA's sales charge rule; and (ii) require UIT depositors to deposit only acquired funds that do not assess a sales load or that waive any sales loads. The conditions in our exemptive orders apply to both investments in affiliated and unaffiliated funds of funds.

Rule 12d1-4 will replace the above-mentioned conditions with the following requirements that will also apply to both affiliated and unaffiliated funds of funds. For management companies, rule 12d1-4 will require the acquiring fund's adviser to evaluate the complexity of the structure and the aggregate fees and expenses associated with the acquiring fund's investment in acquired funds and find that the acquiring fund's fees and expenses do not duplicate the fees and expenses of the acquired fund. As part of this evaluation, the acquiring

fund's adviser should consider, among others, whether such fees incurred by the acquiring fund are based on services that are in addition to, rather than duplicative of, services provided by the acquiring fund's investment adviser. For UITs, rule 12d1-4 will require the principal underwriter or depositor of a UIT to analyze the complexity of the structure associated with the UIT's investment in acquired funds, and find that the arrangement does not result in duplicative fees and expenses. For all acquiring funds, similar to the finding requirement related to undue influence,[647] rule 12d1-4 will require the evaluation of aggregate fees and expenses prior to the initial acquisition of an acquired fund in excess of the limits in section 12(d)(1).

Management companies. In the case of management companies, rule 12d1-4 will replace the specific conditions in our exemptive orders with a broader requirement that the investment adviser to the acquiring fund consider both the complexity and the aggregate fees and expenses of the fund of funds arrangement. We believe that the omission of the specific conditions in our exemptive orders will not compromise investor protection for the following reasons.

First, the omission of the FINRA sales charge limitation from rule 12d1-4 likely will not have an economic effect because the FINRA sales charge rule remains applicable to certain funds (*i.e.*, open-end funds and certain closed-end funds) regardless of the rule's requirements.[648] Second, rule 12d1-4 will replace the requirements in our exemptive orders that (i) the acquiring fund's adviser should waive advisory fees under certain circumstances; and (ii) the acquiring fund's board should make certain findings regarding advisory fees, with a broader requirement that the investment adviser should consider whether fees and expenses are duplicative. We

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647 *See supra* section V.C.1.b.iii.

648 *See* FINRA rule 2341. FINRA rule 2341 does not apply to registered closed-end funds (other than interval funds relying on rule 23c-3 under the Act), BDCs, or UITs (other than "single payment" investment plans that are issued by a UIT). *See* FINRA rule 2341(d).

believe that the fee waiver condition of the existing orders is unnecessary in light of the existing duties and obligations of the fund boards of directors.[649] In addition, the requirement in the exemptive orders that the acquiring fund board find that advisory fees are based on services provided that are in addition to, rather than duplicative of, the services provided by an adviser to an acquired fund is covered by a fund board's fiduciary duties and statutory obligations.

The benefit of the broader fee and expense conditions of rule 12d1-4 relative to the more specific conditions of the exemptive orders is that the acquiring fund's investment adviser will be able to tailor the evaluation of the complexity and the findings regarding aggregate fees and expenses of the fund of funds structure to the needs of each structure, including the consideration of any additional factors that may be appropriate under the circumstances. As a result, the fee conditions of rule 12d1-4 may better protect acquiring fund shareholders from duplicative fees than the conditions in the exemptive orders.[650]

At the same time, the broader fee and expense conditions of rule 12d1-4 relative to the exemptive orders may be more costly to implement and monitor relative to the conditions in the exemptive orders. In particular, rule 12d1-4 will impose one-time costs on funds to review the rule's requirement and modify, as necessary, their policies and procedures to comply with this aspect of rule 12d1-4.

The incremental initial and ongoing costs that management companies will incur whenever they invest for the first time in an acquired fund under rule 12d1-4 include: (i)

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649 *See supra* footnotes 309–313 and accompanying text; *see also* 2018 FOF Proposing Release, *supra* footnote 6, at nn.146–147 and accompanying text.

650 A commenter argued that an additional benefit of the fee and expense conditions of rule 12d1-4 relative to the baseline is that rule 12d1-4 will "lower administrative burden, and appropriately shift the decision-making to the party (the adviser) in the best position to make the assessment" whether the fees and expenses of the fund of funds are reasonable. *See* Invesco Comment Letter.

advisers' initial evaluation of the complexity of the structure and analysis supporting the finding regarding aggregate fees and expenses associated with their investments in acquired funds; (ii) advisers' preparation and reporting of their evaluations, findings, and the basis for their evaluations or findings to the acquiring funds' board of directors; (iii) board time to review the reports prepared by the investment advisers; and (iv) costs of counsel to the independent directors to review the reports prepared by the investment advisers.

The Commission staff estimates that the one-time and ongoing annual costs necessary to comply with the fee and expense conditions of rule 12d1-4 for acquiring management companies will be equal to $45,193 per acquiring management company and will result in an aggregate ongoing burden equal to $148.1 million for all affected acquiring management companies.[651]

UITs. With respect to acquiring UITs, rule 12d1-4 will replace the specific conditions related to sales charges in the exemptive orders with a broader requirement that on or before the date of initial deposit of portfolio securities, the UIT's principal underwriter or depositor evaluate the complexity of the structure and find that the UIT's fees and expenses do not duplicate the fees and expenses of the acquired funds that the UIT holds or will hold at the date of deposit. Similar to the fee and expense conditions of rule 12d1-4 for management companies, the benefit of the broader requirement of rule 12d1-4 for UITs relative to the more specific conditions of the exemptive orders is that the acquiring UIT's depositor or underwriter will be

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651 This estimate is based on the following calculation: $148.1 million = [$14,994 initial and annual internal burden per fund + $35,220 initial external burden per fund (*see* Table 7 in *infra* section VI.B.3.)] x (1 – 10% of the total burden that is associated with the recordkeeping requirements of rule 12d1-4) x 3,278 acquiring management companies that will be subject to rule 12d1-4. 3,278 acquiring management companies that will be subject to rule 12d1-4 = 4,750 acquiring management companies (*see* Table 2 in *supra* section V.B.1) x 69% of acquiring management companies that will be subject to rule 12d1-4 as estimated by a commenter (*see supra* footnote 537 and associated text). This estimate assumes that acquiring management companies with current investments in other funds beyond the limits of section 12(d)(1) will be subject to rule 12d1-4 at the same rate as the acquiring management companies with current investments in other funds within the limits of section 12(d)(1) following the rule adoption.

able to tailor the evaluation of the complexity and finding regarding the aggregate fees and expenses of the fund of funds structure to the needs of each structure and augment, whenever appropriate, the exemptive order conditions with additional appropriate factors. As a result, the UIT fee and expense conditions of rule 12d1-4 may better protect acquiring fund shareholders from duplicative fees than the conditions in the exemptive orders.

At the same time, the broader UIT fee and expense conditions of rule 12d1-4 relative to the exemptive orders may be more costly to implement and monitor relative to the conditions in the exemptive orders. In particular, rule 12d1-4 will impose one-time costs on funds to review the rule's requirement and modify, as necessary, their policies and procedures to comply with the rule. Our staff estimates that the one-time costs necessary to comply with the finding requirement related to fees and expenses of rule 12d1-4 will be equal to $13,187 per acquiring UIT and will result in an aggregate ongoing burden equal to $2.6 million for all affected acquiring UITs.[652] UITs will not bear any ongoing implementation or monitoring costs because they are only required to evaluate the complexity of the structure and make a finding regarding the aggregate fees and expenses associated with the UIT's investment in an acquired fund at the time of initial deposit.

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652 This estimate is based on the following calculation: $2.6 million = $13,187 initial internal and external burden per fund x 200 acquiring UITs that will be subject to rule 12d1-4. $13,187 initial internal and external burden per fund = [$12,253 initial internal burden per fund + $2,400 initial external burden per fund (*see* Table 8 in *infra* section VI.B.4.)] x (1 – 10% of the total burden associated with the recordkeeping requirements of rule 12d1-4). 200 acquiring UITs that will be subject to rule 12d1-4 = 720 UITs (*see* Table 1 in *supra* section V.B.1) x 40% of funds that are acquiring funds x 69% of acquiring UITs that will be subject to rule 12d1-4 as estimated by a commenter (see supra footnote 534 and associated text). 40% of funds that are acquiring funds = 4,750 acquiring funds (*see* Table 2 in *supra* section V.B.1) / 11,788 funds (*see* Table 2 in *supra* section V.B.1). This estimate assumes that acquiring UITs with current investments in other funds beyond the limits of section 12(d)(1) will be subject to rule 12d1-4 at the same rate as the acquiring UITs with current investments in other funds within the limits of section 12(d)(1) following the rule adoption. This estimate also assumes that the percentage of management companies that are acquiring funds is the same as the percentage of UITs that are acquiring funds.

To the extent that the fee and expense conditions of rule 12d1-4 will increase operating costs for management companies and UITs, management companies and UITs could pass through to investors any such cost increases in the form of higher operating expenses.

Variable Annuity Separate Accounts. With respect to separate accounts funding variable insurance contracts,[653] the rule's fees and expenses requirement is the same as the requirement in our current exemptive orders, and thus will not have a significant economic effect. However, to the extent that some insurance companies currently do not provide the same certification to acquiring funds (*e.g.*, because the acquiring funds are able to rely upon section 12(d)(1)(G) and rule 12d1-2 or their orders permit certifications with a different scope), acquiring funds will incur costs to request and insurance companies will incur costs to provide this certification.[654] We lack data that would allow us to estimate how many insurance companies currently do not provide this certification. Relatedly, a commenter stated that its exemptive order requires that the insurance company make a representation to the Commission, rather than the acquiring fund, that the aggregate fees and expenses of the structure are reasonable.[655] We believe that providing a certification to the acquiring fund rather than the Commission will impose minimal additional costs on insurance companies.[656]

v. Fund of Funds Investment Agreement

Our current exemptive orders require a participation agreement between unaffiliated acquiring and acquired funds under which the funds agree to fulfill their responsibilities under the exemptive order. Unless the acquiring and acquired funds have the same investment adviser,

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653 *See* rule 12d1-4(b)(2)(iii).

654 *See* PGIM Comment Letter.

655 *See* Nationwide Comment Letter.

656 *See* Table 9, *infra* section VI.B.5, for relevant cost estimates.

rule 12d1-4 will require the acquiring and acquired funds to 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). The investment agreement must include: (i) any material terms necessary for the adviser, underwriter, or depositor to have made the finding regarding the acquiring fund's investment in the acquired fund; (ii) a termination provision whereby either party can terminate the agreement with advance written notice within a period no longer than 60 days;[657] and (iii) a provision whereby the acquired fund must provide the acquiring fund with fee and expense information to the extent reasonably requested. Hence, the fund of funds investment agreement in rule 12d1-4 is more comprehensive than the participation agreement in our exemptive orders because it (i) applies to both affiliated and unaffiliated fund of funds structures (unless the acquiring and acquired funds share the same primary investment adviser) while the participation agreement in our exemptive orders only applies to unaffiliated funds; and (ii) encompasses a broader set of conditions.[658]

The benefit of a more comprehensive fund of funds investment agreement relative to the participation agreement is that it will enhance investor protection. First, the fund of funds investment agreement will protect investors in both certain affiliated and unaffiliated fund of funds structures from acquiring funds' undue influence, duplicative fees, and complex fund of funds structures. Second, it will allow acquiring and acquired fund boards to monitor better investment advisers' conflicts of interest and the findings of the acquiring and acquired fund

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657 Our exemptive orders do not mandate a specific termination right in the participation agreement. However, the exemptive orders allow acquired funds to terminate the participation agreement subject solely to the giving of notice to a Fund of Funds and the passage of a reasonable notice period and some of the current participation agreements contain a 60-day termination provision. *See supra* footnote 356.

658 Similar to the participation agreement in our exemptive orders, the fund of funds investment agreement in rule 12d1-4 will allow acquired funds to block the acquisition of their shares by certain acquiring funds beyond the limits of section 12(d)(1) by refusing to enter into a fund of funds investment agreement with the acquiring fund.

investment advisers in the context of the fund of funds arrangement.[659] Third, the fund of funds investment agreements will provide a mechanism for acquiring and acquired funds to terminate the arrangement if it is no longer in their respective best interest. Finally, the fund of funds investment agreement will require acquired funds to provide fee and expense information to the acquiring fund, which will assist the acquiring fund's adviser with assessing the impact of fees and expenses associated with an investment in an acquired fund.

By requiring fund of funds investment agreements for both affiliated and unaffiliated funds of funds, rule 12d1-4 will level the playing field for small and large fund complexes relative to the exemptive orders. Funds in smaller complexes are less likely to have sufficient investment opportunities within the fund complex than funds in larger complexes, and thus are more likely to structure unaffiliated funds of funds and bear the costs associated with a participation agreement. Under our current exemptive orders, participation agreements are only required in the case of unaffiliated funds of funds, which may impose a relatively higher burden on funds in smaller complexes. Rule 12d1-4 will require funds to enter into a fund of funds investment agreement both in the case of unaffiliated and affiliated funds of funds (except when the acquiring and acquired funds share the same primary adviser), which will level the playing field for funds that are more likely to structure unaffiliated funds of funds, that is, smaller fund complexes.

The disadvantage of a more comprehensive set of conditions in the fund of funds investment agreements relative to the participation agreements is that fund of funds investment agreements will be more costly to implement and monitor than the participation agreements.[660]

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659 *See* rule 12d1-4(c)(1) recordkeeping requirements.

660 As noted above, fund of funds investment agreements entered into under the rule will be considered

In addition, funds of funds will bear incremental ongoing costs to implement the terms of and monitor compliance with the fund of funds investment agreements. Hence, the one-time and ongoing annual costs borne by acquiring and acquired funds as a result of the requirement to enter into fund of funds investment agreements will be $12,142 for each fund that enters into a fund of funds investment agreement and will result in an aggregate burden equal to $112.2 million for all funds that enter into a fund of funds investment agreement.[661]

vi. Complex Structures

The current exemptive orders prohibit an acquired fund from investing in other investment companies beyond the limits in section 12(d)(1), but they do not prohibit a fund from

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material contracts and thus must be filed as exhibits to each fund's registration statement. *See supra* footnote 359 and accompanying text. While we believe currently that some funds may similarly file participation agreements that are entered into under our exemptive orders as exhibits, this certainty regarding fund of funds investment agreements could result in increased costs to ensure that they are filed. Several commenters argued that the cost of entering into a participation agreement is small, especially because of the standardization of terms and the broad use of participation agreements in the industry. *See*, *e.g.*, Fidelity Comment Letter; Hancock Comment Letter. We expect that the costs associated with preparing and monitoring the fund of funds investment agreements may decrease over time as the fund of funds investment agreements become more standardized.

661 This estimate is based on the following calculation: $112.2 million = [$9,364 internal burden per fund + $2,778 external burden per fund (*see infra* Table 6 in section VI.B.2.)] x 9,240 acquiring-acquired fund pairs that that do not share the same investment adviser and will be subject to rule 12d1-4. 9,240 acquiring-acquired fund pairs that that do not share the same investment adviser and will be subject to rule 12d1-4 = 13,391 acquiring-acquired fund pairs that do not share the same investment adviser x 69% of acquiring-acquired fund pairs that will be subject to rule 12d1-4 as estimated by a commenter (*see supra* footnote 534 and associated text). 13,391 acquiring-acquired fund pairs that do not share the same investment adviser = 30,548 acquiring-acquired fund pairs x 44% of the acquiring-acquired fund pairs that do not share the same investment adviser. We use data from Item C.9 of Form N-CEN to identify a fund's investment adviser. 30,548 acquiring-acquired fund pairs = 24,689 acquiring-acquired fund pairs identified using Form N-PORT data x [14,605 registered investment companies (*see* Table 1 in *supra* section V.B.1) + 83 BDCs (*see supra* footnotes 558 and 559 and associated text)] / [11,788 management companies (*see* Table 2 in *supra* section V.B.1) + 83 BDCs (*see supra* footnotes 558 and 559 and associated text)]. We lack data that would allow us to identify acquiring-acquired fund pairs, for which the acquiring fund is a BDC or a registered investment company that is not a management company. Hence, we assume that acquiring BDCs and acquiring registered investment companies that are not management companies invest in the same number of unique acquired funds as the management companies. Our estimate also assumes that acquiring-acquired fund pairs that are structured beyond the limits of section 12(d)(1) will be subject to rule 12d1-4 at the same rate as acquiring-acquired fund pairs that are structured within the limits of section 12(d)(1) following the rule adoption. Our estimate is likely an upper bound of the cost associated with fund of funds investment agreements because funds of funds that currently have participation agreements in place will only be required to enter into a fund of funds investment agreement if the acquiring fund purchases additional shares of the acquired fund in reliance on the rule.

investing in an acquiring fund beyond the limits in section 12(d)(1). In line with our current exemptive orders, rule 12d1-4 will prohibit an acquired fund from investing beyond the statutory limits in both registered funds and private funds subject to limited exceptions.[662] Nevertheless, the final rule will also expand the complex structures prohibitions included in the exemptive orders in the following ways. First, rule 12d1-4 will prohibit a fund from acquiring in excess of the limits in section 12(d)(1)(A) of the Act (either in reliance on section 12(d)(1)(G) or rule 12d1-4) the outstanding voting securities of an acquiring fund.[663] Second, the rescission of the current exemptive orders will result in the prohibition of multi-tier structures formed in reliance on section 12(d)(1)(G) and those exemptive orders.[664]

The additional complex structures prohibitions of the final rule will limit the creation of multi-tier structures that historically were associated with investor confusion and duplicative and excessive fees before the enactment of section 12(d)(1).[665] Hence, the complex structures conditions of the final rule will enhance investor protection.

At the same time, the final rule will impose costs on funds that may be required to reallocate their portfolio to ensure compliance with the rule. In particular, multi-tier structures that have been formed in reliance on exemptive orders or a combination of exemptive orders and section 12(d)(1)(G) will need to be restructured to the extent that the acquiring fund chooses to invest additional amounts in the existing acquired funds in reliance on this rule. In particular, the

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662 *See* rule 12d1-4(b)(3)(ii).

663 *See* rule 12d1-4(b)(3)(i).

664 As discussed above, an acquiring fund relying on section 12(d)(1)(G) currently can invest in an acquired fund that invests in another fund beyond the limits of section 12(d)(1) in reliance on an exemptive order.

665 As discussed above in section II.C.3.b, multi-tier structures may be difficult for investors to understand even with comprehensive disclosures. Accordingly, the rule includes a general prohibition on three-tier structures, subject to enumerated exceptions and the 10% Bucket for acquired fund investments in other investment companies. *See* rule 12d1-4(b)(3).

top-tier acquiring funds will be required to reallocate their investments to funds that do not invest in underlying funds beyond the 10% limit of rule 12d1-4. Alternatively, the top-tier acquiring funds can invest in the same acquired funds, but those acquired funds will incur costs to reduce their investments in other funds to comply with the limits of rule 12d1-4. Our analysis shows 23 multi-tier structures that are at least three tiers and one multi-tier structure that is four-tiers, for which there is at least one acquiring fund in each level that invests beyond the limits of section 12(d)(1) in at least one acquired fund.[666] For those 23 top-tier acquiring funds, 3.56% of their assets are invested in the second-tier acquired funds that invest in a third-tier acquired fund, and 2.93% of their assets are invested in the third-tier acquired funds, on average. Our analysis, however, should be interpreted with caution because our data does not allow us to distinguish how many of these 23 multi-tier structures are consistent with the exceptions to the complex structures prohibitions of rule 12d1-4.

Section VI.C.1.a above provides a detailed discussion of the costs associated with portfolio reallocations. Any costs that funds will incur to restructure their investments will be moderated by the fact that funds will have a period to bring their operations into compliance with the final rule.[667]

In addition, funds that will operate in accordance with rule 12d1-4 to create fund of funds structures will need to implement policies and procedures to monitor their investments in other funds beyond the limits of section 12(d)(1) to ensure compliance with the complex structures conditions of rule 12d1-4. We believe that any such additional costs may be mitigated to the extent that many of the complex structures conditions of rule 12d1-4 are similar to the

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666 *See supra* footnote 551 and associated text.

667 *See supra* section III.

complex structures conditions in our exemptive orders and funds already have policies and procedures to monitor their investments in other funds for compliance with the terms of the exemptive orders. Those policies and procedures may be leveraged to monitor compliance with the complex structures conditions of rule 12d1-4.

Finally, as discussed in detail in Section V.C.1.i above, the restrictions on multi-tier structures will affect both current and prospective funds by restricting their investment flexibility, thus reducing investment options available to fund investors.

vii. Recordkeeping

Our exemptive orders generally require the unaffiliated acquiring and acquired funds to maintain (i) records of the exemptive order; (ii) records of the participation agreement; and (iii) a list of the names of each fund of funds affiliate and underwriting affiliate. Further, our exemptive orders require the unaffiliated acquired funds to maintain a written copy of the policies and procedures (and any modifications to such policies and procedures) that the acquired funds put in place to monitor any purchases of securities from the acquiring fund or its affiliates. The recordkeeping requirements in our exemptive orders are for a period of not less than six years, and the records must be maintained in an easily accessible place in the first two years.

Rule 12d1-4 will require both affiliated and unaffiliated acquiring and acquired funds to maintain (i) a copy of each fund of funds investment agreement; (ii) for management companies and UITs, a written record of the acquiring and acquired funds' evaluations and findings, and the basis for such evaluations and findings; and (iii) for separate accounts funding variable insurance contracts, the certification provided by the insurance company. Rule 12d1-4 will require 5 years of recordkeeping and, similar to the orders, it will require records to be maintained in an easily accessible place in the first two years.

The recordkeeping requirements of rule 12d1-4 are more extensive than the recordkeeping requirements in our exemptive orders because (i) they apply to both affiliated and unaffiliated funds of funds while the recordkeeping requirements in our exemptive orders only apply to unaffiliated funds of funds; and (ii) they apply to both acquiring and acquired funds while only certain of the recordkeeping requirements in our exemptive orders apply to both acquiring and acquired funds.[668] At the same time, the recordkeeping requirements of rule 12d1-4 have a shorter duration than the recordkeeping requirements of our exemptive orders (*i.e.*, five years under the rule instead of six years under the orders). Further, the undue influence findings of rule 12d1-4 are only required prior to the initial acquisition of the acquired fund shares while the determinations in our exemptive orders apply periodically (*i.e.*, at least annually). Consequently, the associated recordkeeping of rule 12d1-4 will be less burdensome than the associated recordkeeping in our exemptive orders.

The benefit of any more extensive recordkeeping requirements is that they will allow for Commission examinations of investment advisers' investing decisions, which may ultimately benefit fund investors. The disadvantage of any more extensive recordkeeping requirements of rule 12d1-4 relative to our exemptive orders is that it will impose higher costs on funds and their investors. We estimate that each acquiring and acquired management company will bear annual recordkeeping costs equal to $5,021, each acquiring UIT will bear annual recordkeeping costs equal to $1,465, each separate account will bear annual recordkeeping costs equal to $65, and each fund that enters into a fund of funds investment agreement will bear annual recordkeeping

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668 The recordkeeping requirements in our exemptive orders related to purchases in affiliated underwritings only apply to acquired funds.

costs equal to $954, which will result in aggregate ongoing annual recordkeeping costs equal to $40.1 million.[669]

2. Effects on Efficiency, Competition, and Capital Formation

i. Efficiency

Efficiency of current and prospective acquiring funds' asset allocation. The final rule will have opposing effects on the efficiency of current and prospective acquiring funds' asset allocation. More specifically, the final rule may promote the efficiency of funds' asset allocation

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669 This estimate is based on the following calculation: $40.1 million = $14.6 million recordkeeping cost associated with the undue influence finding of rule 12d1-4 for acquired management companies + $16.5 million recordkeeping cost associated with the fee and expense finding of rule 12d1-4 for acquiring management companies + $0.3 million recordkeeping cost associated with the fee and expense finding for acquiring UITs + $0.01 million recordkeeping cost associated with the recordkeeping requirement for separate accounts + $8.8 million recordkeeping cost associated with the fund of funds investment agreement. $14.6 million recordkeeping cost associated with the undue influence finding of rule 12d1-4 for acquired management companies = [$14,994 initial and annual internal burden per fund + $35,220 initial external burden per fund (*see* Table 7 in *infra* section VI.B.3.)] x 10% of the total burden that is associated with the recordkeeping requirements of rule 12d1-4 x 2,900 acquired management companies that will be subject to rule 12d1-4 (*see supra* footnote 646). $16.5 million recordkeeping cost associated with the fee and expense finding of rule 12d1-4 for acquiring management companies = [$14,994 initial and annual internal burden per fund + $35,220 initial external burden per fund (*see* Table 7 in *infra* section VI.B.3.)] x 10% of the total burden that is associated with the recordkeeping requirements of rule 12d1-4 x 3,278 acquiring management companies that will be subject to rule 12d1-4 (*see supra* footnote 651). $0.3 million recordkeeping cost associated with the fee and expense finding for acquiring UITs = [$12,253 initial internal burden per fund + $2,400 initial external burden per fund (*see* Table 8 in *infra* section VI.B.4.)] x 10% of the total burden that is associated with the recordkeeping requirements of rule 12d1-4 x 200 acquiring UITs that will be subject to rule 12d1-4 (*see supra* footnote 652). $0.01 million recordkeeping cost associated with the recordkeeping requirement for separate accounts = $649 internal burden per fund (*see* Table 9 in *infra* section VI.B.5) x 10% of the total burden that is associated with the recordkeeping requirements of rule 12d1-4 x 191 acquiring separate accounts that will be subject to rule 12d1-4. 191 acquiring separate accounts that will be subject to rule 12d1-4 = [430 variable annuity separate accounts registered as UITs (*see* Table 1 in *supra* section V.B.1) + 243 variable life insurance separate accounts registered as UITs (*see* Table 1 in *supra* section V.B.1) + 14 management company separate accounts (*see* Table 1 in *supra* section V.B.1)] x 40% of funds that are acquiring funds (*see supra* footnote 652) x 69% of acquiring separate accounts that will be subject to rule 12d1-4 as estimated by a commenter (*see supra* footnote 534 and associated text). This estimate assumes that acquiring separate accounts with current investments in other funds beyond the limits of section 12(d)(1) will be subject to rule 12d1-4 at the same rate as the acquiring separate accounts with current investments in other funds within the limits of section 12(d)(1) following the rule adoption. This estimate also assumes that the percentage of management companies that are acquiring funds is the same as the percentage of separate accounts that are acquiring funds. $8.8 million recordkeeping cost associated with the fund of funds investment agreement = $954 recordkeeping cost associated with the fund of funds investment agreements (*see* Table 6 in *infra* section VI.B.2.) x 9,240 acquiring-acquired funds pairs that that do not share the same investment adviser and will be subject to rule 12d1-4 (*see supra* footnote 661).

for the following reasons. First, the final rule will eliminate the need for funds to apply for an exemptive order to structure certain funds of funds.[670] By eliminating the need for funds of funds to apply for an exemptive order, the final rule will reduce certain frictions in funds' asset allocation that are caused by the expense and delays associated with the exemptive order process, and thus may promote the efficient allocation of funds' assets.[671]

Second, rule 12d1-4 may increase the efficiency of certain funds' asset allocation. This is because rule 12d1-4 may increase funds' investment flexibility by expanding the scope of permissible acquiring and acquired funds relative to the current exemptive orders and broadening some of the exemptions to the complex structures prohibitions relative to the current exemptive orders and staff no-action letters, and thus may make it easier for funds to create an investment portfolio that better meets their investors' risk-return preferences.

Third, the final rule will create a more consistent and efficient regulatory framework for funds of funds than the existing regulatory framework for the following reasons.[672] First, rule 12d1-4 provides the same investment flexibility to all registered funds and BDCs. Second, under the existing regulatory framework, substantially similar funds of funds are subject to different conditions. For example, an acquiring fund currently can rely on section 12(d)(1)(G) and rule 12d1-2 to invest in an acquired fund within the same group of investment companies or, alternatively, can rely on relief provided by the Commission to achieve the same investment objectives. The final rule will eliminate the existing overlapping and potentially inconsistent

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670 *See supra* section V.B.2.a for discussion of the costs associated with the exemptive orders.

671 *See*, *e.g.*, Morningstar Comment Letter.

See supra section V.B.2.a for discussion of costs associated with the exemptive order process.

672 *See*, *e.g.*, Nationwide Comment Letter; Invesco Comment Letter; ICI Comment Letter; Advent Comment Letter; Hancock Comment Letter; Clifford Chance Comment Letter; Schwab Comment Letter; Blackrock Comment Letter; Morningstar Comment Letter for commenters agreeing with our assessment that rule 12d1-4 will create a more efficient regulatory framework for funds of funds.

conditions for funds of funds and harmonize conditions across different fund arrangements.[673] This may remove obstacles to funds' investments and operations to the extent that regulatory consistency and efficiency decreases compliance and operating costs. By reducing compliance and operating costs, the final rule will further reduce frictions in asset allocation and may promote the efficient allocation of funds' assets.

At the same time, the final rule may decrease the efficiency of certain funds' asset allocation by prohibiting certain existing funds of funds and requiring the restructuring of additional investments in other funds to ensure compliance with the rule. The new prohibition on certain fund structures may leave certain funds less able to diversify their investment portfolio or efficiently determine the funds in which they invest or their allocation of assets.

In addition, the new conditions of rule 12d1-4, and the rule's omission of certain conditions contained in our exemptive orders, will also affect the cost of operations of funds of funds.[674] Nevertheless, the net effect of the new and omitted conditions on the funds' cost of operations is unclear because we are unable to quantify the effect of many of these conditions. To the extent that the net effect of the new and omitted conditions will be to increase the cost of operations for funds of funds,[675] those conditions may ultimately reduce the efficient allocation of acquiring fund assets.

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673 In particular, affiliated funds of funds currently can be structured either under section 12(d)(1)(G) and rule 12d1-2 or under exemptive orders, and each alternative subjects affiliated funds of funds to different conditions. In addition, funds that are structured under different exemptive orders may be subject to somewhat different conditions. Finally, unlike rule 12d1-4, our exemptive orders provide relief from section 12(d)(1) to a subset of registered investment companies and BDCs, and thus provide different levels of flexibility depending on the fund type.

674 *See supra* section V.C.1.b for a detailed discussion of the costs and benefits of the new and omitted conditions.

675 We believe that the new and omitted conditions of rule 12d1-4 may increase certain funds' cost of operations but at the same time will enhance investor protection.

Efficiency of the asset allocation of current and prospective acquiring fund investors. The final rule may promote the efficiency of investors' asset allocation. First, rule 12d1-4 will reduce the cost of setting up a fund of funds by eliminating the need to apply for an exemptive order. To the extent that the fund industry is competitive,[676] fund advisers/sponsors might pass through to investors the cost savings associated with eliminating the need to apply for an exemptive order, which might result in lower fees and expenses for acquiring fund investors. Lower fees and expenses, in turn, might result in improved efficiency of investors' asset allocation because investors can achieve the same investment objectives at a potentially lower cost. Similarly, the final rule will create a more consistent and more efficient regulatory framework. Fund advisers/sponsors might also pass through to investors any cost savings associated with a more consistent and efficient regulatory framework, which might result in lower fees and expenses, and more efficient allocation of acquiring fund investors' assets.

Second, rule 12d1-4 may increase funds' investment flexibility by expanding the scope of permissible acquiring and acquired funds relative to the current exemptive orders and broadening some of the exemptions to the complex structures prohibitions relative to the current exemptive orders and staff no-action letters. The rule will therefore increase the diversity of available funds of funds and may promote the efficient allocation of acquiring fund investors' assets because investors will be better able to achieve their investment objectives.[677]

Third, having one uniform rule that applies to registered investment companies and BDCs may improve acquiring fund investors' ability to efficiently allocate their assets because it

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676 *See supra* footnotes 611 and 612.

677 Rule 12d1-4 may also increase innovation in the fund industry by allowing funds and advisers seeking exemptions to focus resources on novel products or arrangements rather than preparing and reviewing exemptive orders.

will be easier for these investors to understand fund of funds operations and it will simplify across-fund comparisons of various fund characteristics (*e.g.*, liquidity) because investors will no longer be required to adjust for differences in regulatory requirements across funds when making cross-fund comparisons for investment decision-making purposes.[678]

On the other hand, there are ways in which the final rule might reduce the efficiency of investors' asset allocation. In particular, the final rule may increase the costs of operations for acquiring and acquired funds because the cost of implementation and monitoring of the rule's conditions may be higher than the cost of implementation and monitoring of the conditions in our current exemptive orders. To the extent that any increased costs are passed through to investors, the fees and expenses for acquiring and acquired fund investors may increase. Higher fees and expenses, in turn, might negatively affect the efficiency of investors' asset allocation. In addition, rule 12d1-4 might decrease the diversity of funds of funds' investment strategies because it might reduce acquiring funds' investment flexibility by decreasing their ability to create certain multi-tier structures. A decrease in the diversity of available funds of funds may reduce the efficient allocation of investors' assets because investors may be less able to achieve their investment objectives.

Efficiency of prices of acquired funds and their underlying assets. The final rule may have opposing effects on the efficiency of prices of acquired funds and their underlying assets. In particular, the final rule may have a positive impact on the efficiency of the prices of acquired funds and their underlying assets. More specifically, rule 12d1-4 may (i) increase the diversity of certain funds of funds by expanding the scope of permissible acquiring and acquired funds;[679]

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678 *See*, *e.g.*, Morningstar Comment Letter.

679 As discussed in section V.C.1.a.i. above, the net effect of the final rule on funds' investment flexibility is

(ii) increase the number of available funds of funds by eliminating the need to apply for an exemptive order and by creating a more consistent and more efficient regulatory framework; and (iii) enhance investor protection against acquiring funds' undue influence, duplicative fees, and complex structures. The potential increase in the diversity and number of funds of funds and the enhancement of investor protection may increase the attractiveness of funds of funds, and thus might increase investors' demand for funds of funds. The increased investor demand for funds of funds may increase investment rates, increase investments in acquiring funds, and thus increase investments in the acquired funds and the acquired funds' underlying assets (*i.e.*, stocks, bonds, etc.). An increased investment in the acquired funds and the acquired funds' underlying assets may increase trading interest for those assets. Higher trading interest might lead to higher liquidity, lower trading costs, improved information production, and thus more efficient prices for those assets.[680]

In addition, the final rule may increase the price efficiency of listed acquired funds *(i.e.*, ETFs, ETMFs, listed closed-end funds, and listed BDCs) because investors may increase their investments in those funds through investments in funds of funds rather than investing directly in those funds. Consequently, the funds' investor base may shift from individual investors to acquiring funds. A shift of certain funds' investor base to more financially sophisticated investors may in turn result in more efficient prices for listed acquired funds.[681] Financially

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unclear. To the extent that the final rule will decrease funds' investment flexibility, it could decrease the diversity of available funds of funds.

680 *See*, *e.g.*, Anat R. Admati & Paul Pfleiderer, *A Theory of Intraday Patterns: Volume and Price Variability*, 1 REV. FIN. STUD. 3 (1988); Tarun Chordia, Richard Roll, & Avanidhar Subrahmanyam, *Liquidity and Market Efficiency*, 87 J. FIN. ECON. 249 (2008). For ETFs, there is mixed evidence on the effects of ETF ownership on the liquidity and price efficiency of underlying assets. *See* 2019 ETF Adopting Release, *supra* footnote 25, at 57219 for a more detailed discussion.

681 *See*, *e.g.*, Eli Bartov, Suresh Radhakrishnan, & Itzhak Krinsky, *Investor Sophistication and Patterns in Stock Returns after Earnings Announcements*, 75 ACC. REV. 43 (2000); Joseph D. Piotroski & Darren T.

sophisticated investors may improve price efficiency through both aggressive and passive trading.[682] For example, financially sophisticated investors may tend more frequently to trade based on information obtained through their research and analysis (*i.e.*, aggressive trading). To the extent they perceive a potentially profitable trading opportunity, they must execute their trades while the security remains potentially mispriced before their information gets impounded into prices. Hence, financially sophisticated investors that trade on information may tend to place aggressive orders that move prices closer to fundamentals. Financially sophisticated investors may also improve price efficiency by providing liquidity to uninformed traders (*i.e.*, passive trading). More specifically, to the extent financially sophisticated investors may be able to distinguish between informed and uninformed investors, financially sophisticated investors may be more willing to provide liquidity to uninformed investors, and thus improve price efficiency by enhancing market liquidity.

On the other hand, any potential increase in acquiring and acquired funds' cost of operations as a result of the more comprehensive conditions of rule 12d1-4 relative to the conditions in the exemptive orders and rule 12d1-2, and any potential decrease in available fund of funds structures due to additional prohibitions on multi-tier structures, will have the opposite effect on the efficiency of prices of acquired funds and their underlying assets.

Roulstone, *The Influence of Analysts, Institutional Investors, and Insiders on the Incorporation of Market, Industry, and Firm-Specific Information into Stock Prices*, 79 ACC. REV. 1119 (2004); Ekkehart Boehmer & Eric K. Kelley, *Institutional Investors and the Informational Efficiency of Prices*, 22 REV. FIN. STUD. 3563 (2009) ("Boehmer & Kelley (2009)"). *See also* Franklin Comment Letter (arguing that the final rule will increase institutional ownership for BDCs, which "would support BDC share prices, trading volume and the depth and liquidity of the BDC market…promote better corporate governance and management oversight as well as more insightful analysis of the BDC market through increased third-party analyst coverage and research reports…[and] support capital formation while decreasing BDCs' cost of capital, meaning that BDCs could invest more, and on better terms, in the portfolio companies that rely on them.").

682 Boehmer & Kelley (2009), *supra* footnote 681.

ii. Competition

Certain aspects of the final rule may have opposing effects on fund competition. On one hand, the final rule might promote competition in the fund industry for the following reasons. First, to the extent that rule 12d1-4 increases acquiring funds' investment flexibility, the final rule might promote competition in the fund industry because it will increase the diversity of available funds of funds.[683] Second, the final rule will level the playing field for funds by expanding the scope of permissible acquiring and acquired funds, mandating the same conditions for similar funds of funds, and imposing more similar conditions on affiliated and unaffiliated fund of funds structures.[684] A more level playing field might increase competition in the fund industry because it will allow various funds to operate under similar regulatory restrictions and thus funds will bear similar costs associated with regulatory restrictions. To the extent that regulatory inefficiencies and inconsistencies might hamper funds' investment and growth, an increase in regulatory consistency and efficiency might result in the creation of more funds of funds, which might increase competition in the fund industry. Fourth, rule 12d1-4 will remove the need to apply for an exemptive order and thus will decrease the cost of setting up a fund of funds. To the extent that a decrease in the cost of setting up a fund of funds may lower the

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683 Funds can choose to compete through prices or through product differentiation. *See*, *e.g.*, Avner Shaked & John Sutton, *Relaxing Price Competition Through Product Differentiation*, 49 REV. ECON. STUD. 3 (1982).

684 *See*, *e.g.*, Morningstar Comment Letter. As discussed in *supra* section I, the combination of statutory exemptions, Commission rules, and the exemptive orders has created a regime where substantially similar funds of funds are subject to different conditions. The final rule will level the playing field for funds because it will create a regime where similar funds of funds are subject to the same conditions. At the same time, any effects of leveling the playing field will be limited by the fact that different funds face different levels of restrictions on their investments that are unrelated to rule 12d1-4 (*see*, *e.g.*, *supra* footnote 39 for restrictions on BDC investments).

barriers to entry for new funds of funds, it thus might increase competition in the fund industry.[685]

At the same time, to the extent that the final rule will decrease certain funds' investment flexibility or increase the cost of operations for certain funds that will operate in accordance with rule 12d1-4, it might reduce competition among funds of funds because it will decrease the diversity of available funds of funds.

iii. Capital Formation

The impact of the final rule on capital formation is unclear. On one hand, the final rule might have a positive effect on capital formation if it causes investors to commit more of their financial resources to investments in securities in aggregate. Specifically, the potential increase in fund investment flexibility, the potential leveling of the playing field as a result of the final rule, the increase in regulatory consistency and efficiency, and the potential decrease in the operating costs of prospective funds of funds as a result of removing the need to apply for an exemptive order may increase the number and diversity of funds of funds. An increase in the number and diversity of funds of funds may attract additional investment in funds of funds, and ultimately increase demand for the funds of funds' underlying securities. Investor demand for funds of funds also may increase as a result of the new conditions of rule 12d1-4, which will enhance investor protection. As a result of the increased demand for the firms' equity and debt securities, companies might be able to issue new debt and equity at higher prices, and therefore decrease the cost of capital of firms, thus facilitating capital formation.[686]

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[685] Any beneficial effects of the rule on competition may be muted to the extent that existing funds of funds may incur costs to comply with the rule conditions (*e.g.*, costs associated with portfolio restructuring).

[686] Academic literature provides evidence consistent with the idea that higher demand for a firm's securities could lead to lower cost of capital. *See*, *e.g.*, Douglas W. Diamond & Robert E. Verrecchia, *Disclosure, Liquidity, and the Cost of Capital*, 46 J. FIN. 1325 (1991).

On the other hand, to the extent that single-tier funds and funds of funds are purely substitute investments, an increase in investors' demand for funds of funds may decrease the demand for single-tier fund structures, leaving aggregate demand for the underlying securities unchanged. Consequently, under this scenario, there will be no change in the amount of money that flows to issuers and there will be no impact on capital formation as a result of the final rule. In addition, a potential increase in the operating costs of acquiring and acquired funds as a result of the rule's conditions may reduce capital formation to the extent that there is a decrease in the amount of money available to be employed in value-generating activities.

At the same time, the potential decrease in fund investment flexibility and the potential increase in the funds' cost of operations as a result of the final rule may have the opposite effect on capital formation. In particular, the potential decrease in fund investment flexibility and the potential increase in the funds' cost of operations may decrease the number and diversity of funds of funds. A decrease in the number and diversity of funds of funds may discourage investments in funds of funds, and ultimately decrease demand for the funds of funds' underlying securities. As a result of the decreased demand for the firms' equity and debt securities, companies may be forced to issue new debt and equity at lower prices, and therefore increase the cost of capital of firms, thus impeding capital formation.

Nevertheless, we do not expect that the final rule will have significant effects on investors' investment rates.

D. Reasonable Alternatives

1. Retain Existing Exemptive Relief

As discussed in section III above, we are rescinding, as proposed, the exemptive relief permitting fund of funds arrangements that fall within the scope of rule 12d1-4. Alternatively, we could allow existing funds of funds to choose whether to operate indefinitely under the

existing exemptive relief or rule 12d1-4, and require only new funds of funds to comply with rule 12d1-4.[687] The benefit of such an alternative would be that existing funds of funds would not incur the one-time switching costs from the exemptive order conditions to the conditions of rule 12d1-4 and will not incur costs associated with reduced investment flexibility as a result of the complex structure conditions of the rule relative to the exemptive orders,[688] which could ultimately benefit those funds' investors. At the same time, however, this alternative would subject existing funds of funds and new funds of funds to different sets of conditions. For example, existing funds of funds would be exempt from the rule's new requirements relating to fund of funds investment agreements, findings, and multi-tier structures. Consequently, unlike the final rule, this alternative would establish a less uniform regulatory framework governing fund of funds arrangements and would not include the benefit of enhanced investor protection that is afforded by the rule's conditions.

2. Retain Rule 12d1-2

We considered not rescinding rule 12d1-2 but instead allowing funds to operate under either rule 12d1-4 or section 12(d)(1)(G) and rule 12d1-2.[689] The advantage of such an approach would be that funds that choose to operate in accordance with section 12(d)(1)(G) and rule 12d1-2 will not be required to modify their operations to comply with the conditions of rule 12d1-4 and incur the associated costs or potentially restructure their investments to comply with the amended regulatory framework.[690] The main disadvantages of such an alternative would be that

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687 *See supra* footnote 493.

688 *See supra* section V.C.1.a.i for a comparison of the complex structure conditions of rule 12d1-4 relative to the exemptive orders.

689 *See supra* footnote 450. Our analysis shows that there are 954, or 20%, of all acquiring funds that currently rely on section 12(d)(1)(G) and rule 12d1-2 to structure affiliated funds of funds. *See supra* section V.B.1.

690 Many commenters opposed the rescission of rule 12d1-2. *See, e.g.*, Allianz Comment Letter; Invesco

(i) various funds would not operate under a consistent and efficient regulatory framework because similar funds of funds would operate under different conditions; and (ii) investors in affiliated funds of funds would not enjoy the enhanced investor protection afforded by the conditions of rule 12d1-4.

3. Allow Private and Unregistered Investment Companies to Rely on Rule 12d1-4

As discussed above, rule 12d1-4 will permit certain registered investment companies and BDCs to invest in certain registered investment companies and BDCs beyond the limits in section 12(d)(1). Alternatively, we could expand the scope of rule 12d1-4 to allow private funds and unregistered investment companies to rely on the rule as acquiring funds.[691] Expanding rule 12d1-4 in this manner would (i) increase investment flexibility for private and unregistered acquiring funds and their investors; (ii) level the playing field across registered and private and unregistered acquiring funds because they would enjoy the same investment flexibility and be subject to the same conditions; and (iii) benefit acquired registered investment companies and BDCs by increasing private and unregistered funds' investments in them, thus enhancing their liquidity and increasing their scale, which would result in efficiency gains for those acquired funds.[692]

Comment Letter; Thrivent Comment Letter, PIMCO Comment Letter; Fidelity Rutland Comment Letter; Schwab Comment Letter; NYC Bar Comment Letter; PGIM Comment Letter, BlackRock Comment Letter; ABA Comment Letter; SIFMA AMG Comment Letter; Capital Group Comment Letter. *See supra* section II.D.1 for detailed discussion of arguments raised by commenters. Some of the commenter concerns may have been addressed given that the rule will not include a redemption limit and the rule will permit acquired funds to invest up to 10% of their assets in other funds.

691 *See supra* footnote 47 for commenters supporting this alternative.

692 *See*, *e.g.*, MFA Comment Letter; Parallax Comment Letter; NYC Bar Comment Letter; Dechert Comment Letter; Blackrock Comment Letter discussing the benefits of expanding the scope of rule 12d1-4 to private funds and unregistered investment companies.

Nevertheless, we continue to believe that there are risks associated with expanding rule 12d1-4 to acquiring private funds and unregistered investment companies. First, private funds and unregistered investment companies are not registered with the Commission and would not be subject to the same reporting requirements (*i.e.*, Forms N-CEN and N-PORT) as registered investment companies.[693] Accordingly, the Commission does not receive routine reporting on the amount and duration of private fund or unregistered investment company investments in registered funds. Without imposing reporting requirements on private funds and unregistered investment companies, it would be difficult for the Commission to monitor potential undue influence by such funds, or to monitor their compliance with rule 12d1-4. Second, private funds and unregistered investment companies are not subject to the governance and compliance requirements under the Investment Company Act, which are designed to protect investors and reduce conflicts of interest that are inherent in a fund structure and are integral to the oversight and monitoring provisions of rule 12d1-4 for registered funds. Third, unregistered foreign funds' investments in U.S. registered funds have raised concerns of abuse and undue influence in the past, which gave rise to Congress's amendments to section 12(d)(1) in 1970. Finally, as commenters noted, the Commission does not have experience with this type of fund of funds arrangement because it has not yet extended exemptive relief allowing such funds to acquire other investment companies in excess of the section 12(d)(1) limits.[694] Without that experience, the Commission is not able to determine at this time that the rule's conditions and protections would apply as appropriately to private funds and unregistered investment companies or be properly tailored to prevent the abuses that led Congress to enact section 12(d)(1).

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[693] *See supra* section II.A.2.

[694] *See supra* footnote 53.

4. Codify Current Conditions in Existing Exemptive Orders

As discussed above, rule 12d1-4 will not include certain conditions contained in current exemptive orders that we believe are not necessary to prevent the abuses that section 12(d)(1) seeks to curtail in light of the new conditions being adopted. Rule 12d1-4 also will include new conditions to address the potential for undue influence, complex structures, or duplicative fees. Alternatively, we could codify the conditions contained in existing exemptive orders rather than replacing certain conditions with alternative conditions as contained in rule 12d1-4.[695]

This alternative approach would not impose the costs associated with the new conditions in rule 12d1-4, but it might impose costs to the extent that the conditions in the orders on which some funds of funds rely might not be identical to the conditions in this alternative rule because of cross-sectional variation in the conditions of the exemptive orders. We also believe that this alternative approach would not be as effective at preventing the abuses that section 12(d)(1) seeks to curtail while eliminating conditions that are not necessary in light of the new conditions of rule 12d1-4. In particular, we believe that the conditions in rule 12d1-4 may enhance investor protection relative to the exemptive orders by imposing certain requirements (*i.e.*, findings and fund of funds investment agreement) on both affiliated and unaffiliated funds of funds and by prohibiting certain multi-tier structures.

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[695] *See supra* footnote 488.

5. Restrict the Ability of an Acquiring Fund and its Advisory Group to Invest in an Acquired Fund above a Lower or Higher Limit than the Adopted Control Limit

As discussed in section II.C.1.a above, to address concerns about one fund exerting undue influence over another fund, rule 12d1-4 is not available when an acquiring fund together with its advisory group controls the acquired fund. Rule 12d1-4 relies on the definition of "control" in the Act, including the rebuttable presumption that any person who directly or indirectly beneficially owns more than 25% of the voting securities of a company controls that company. Rule 12d1-4 includes an exception for funds that are in the same group of investment companies. Rule 12d1-4 also includes an exception when 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.

As an alternative means of preventing undue influence, we could instead restrict the ability of an acquiring fund and its advisory group to invest in an acquired fund above a lower limit than the 25% limit used to define "control" in the Act.[696] A lower limit could provide additional assurance that rule 12d1-4 would protect investors from the abusive practices that section 12(d)(1) was designed to prevent because a lower percentage of ownership would reduce the risk that the acquiring fund could exercise undue influence over the acquired fund's strategy,

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696 Some commenters argued that the control condition should be lower than 25% for acquired closed-end funds because closed-end funds are frequently subject to investor activism. *See*, *e.g.*, Gabelli Comment Letter; Comment Letter of John Birch (April 22, 2019); Comment Letter of Kuni Nakamura (April 25, 2020); Advent Comment Letter. *See also supra* footnotes 121 and 122. Other commenters, however, argued that the 25% threshold is appropriate because investor activism can be beneficial to fund investors. *See*, *e.g.*, Saba Comment Letter; City of London Comment Letter. As a response to commenters that argued that investor activism for closed-end funds is harmful, we note that academic literature provides evidence consistent with the idea that investor activism can be beneficial for closed-end fund investors because it has the potential to increase the market value of closed-end funds and mitigate managerial entrenchment. *See*, *e.g.*, Matthew E. Souther, *The Effects of Takeover Defenses: Evidence from Closed-End Funds*, 119 J. FIN. ECON. 420 (2016); Michael Bradley et al., *Activist Arbitrage: A Study of Open-Ending Attempts of Closed-End Funds*, 95 J. FIN. ECON. 1 (2010).

management, or governance.[697] However, a lower limit could hamper the acquiring fund's ability to achieve its investment strategy in an efficient and cost effective manner.[698]

We also could impose a lower limit while narrowing the scope of entities that would be assessed for the purposes of the ownership threshold.[699] In particular, the ownership limit could apply only to the acquiring fund and other funds advised by the same adviser or by the adviser's control affiliates. As a result, acquiring funds would not be required to consider their non-fund affiliates' holdings when assessing whether they control an acquired fund, which would lessen compliance burdens for the acquiring funds. Nevertheless, our exemptive orders define control in terms of a fund and its advisory group. Consequently, funds likely already have established policies and procedures to monitor compliance with the aggregation requirement embedded in the rule's definition of an acquiring fund's "advisory group." In addition, other provisions of the Act and our rules also extend to affiliated persons of an investment adviser, and so funds (or their advisers) have experience developing compliance policies and procedures in those circumstances. Lastly, the risk of undue influence over an acquired fund will be more effectively addressed by requiring all entities within an advisory group to aggregate their holdings for purposes of the control condition because entities in the same advisory group could potentially coordinate to exercise undue influence over the acquired funds.[700]

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697 As discussed in section II.B above, section 17 of the Act generally restricts a fund's ability to enter into transactions with affiliated persons and thus provides some protection to acquired funds from acquiring funds' undue influence. Rule 12d1-4 also contains a number of conditions aimed at protecting acquired funds from acquiring funds' undue influence.

698 The control condition could, for example, limit an acquiring fund from obtaining the optimal level of risk exposure to another fund. Acquiring funds potentially could obtain similar levels of risk exposure at a higher cost by investing in multiple funds.

699 *See supra* footnotes 106–110.

700 For example, a family of target date funds tends to invest in different proportional allotments of the same underlying funds.

Similarly, we could impose a limit higher than 25%, which would provide acquiring funds with greater investment flexibility. However, we believe that a limit higher than 25% would be more likely to give rise to the abuses that section 12(d)(1) was designed to prevent because it would make it more likely that the acquiring fund could control the acquired fund and thus potentially influence the acquired fund for the benefit of the acquiring fund's shareholders, advisers, or sponsors to the detriment of acquired fund investors.

6. Permit Multi-Tier Fund Structures

As discussed above, rule 12d1-4 will limit the creation of certain multi-tier structures. As an alternative, we could allow all multi-tier fund structures that are currently permissible.[701] While this alternative would provide greater flexibility to funds to meet their investment objectives, the organizational complexity of multi-tier fund structures could make it difficult for acquired fund investors to understand who controls the fund and acquiring fund investors may find it difficult to understand the true asset exposure of the acquiring fund.[702] It could also raise concerns associated with duplicative and excessive fees. Additionally, we believe that the rule's exceptions to the multi-tier structures prohibition and 10% Bucket provide sufficient investment and funding flexibility to acquiring and acquired funds.

7. Alternative Control Conditions

a. Redemption Limit

We proposed a redemption limit that would prohibit an acquiring fund that acquires more than 3% of an acquired fund's outstanding shares from redeeming, submitting for redemption, or

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701 *See supra* footnotes 369, 370, 371, and 373.

702 Alternatively, concerns of investor confusion could be addressed by increasing disclosure requirements regarding multi-tier structures. However, we believe that enhanced disclosure requirements may not be sufficient to mitigate concerns of investor confusion.

tendering for repurchase more than 3% of an acquired fund's total outstanding shares in any 30-day period. The purpose of this prohibition was to address concerns that an acquiring fund could threaten large-scale redemptions to unduly influence an acquired fund. Using data from Form N-PORT filings that were filed with the Commission between May 2019 and July 2020, we find that 1,304 funds out of a total of 3,654 held more than 3% of any acquired fund's shares at the end of a reporting period, and thus could have been affected by the proposed redemption limit. Our analysis also shows that the average (median) 30-day redemption was 0.32% (0.011%): the average (median) 30-day redemption for listed acquired funds was 0.13% (0.003%) and for unlisted acquired funds was 0.45% (0.027%). Finally, there were 1,961 instances in which an acquiring fund redeemed more than 3% of an acquired fund's shares in any 30-day period, representing 578 unique funds.[703] When looking at fund redemptions in March 2020, a presumed period of market stress, the average (median) 30-day redemption was 0.69% (0.033%).

An acquiring fund that holds 25% of the outstanding shares of an acquired fund (*i.e.*, up to the control limit) and can only redeem 3% of the acquired fund shares in every 30-day period (*i.e.*, up to the redemption limit) would take 10 months to fully unwind its investment in the acquired fund, assuming no other concurrent changes in the number of acquired fund shares outstanding that are unrelated to the acquiring fund's redemptions. It would take longer than 10 months for an acquiring fund to redeem the acquired fund shares if other investors were concurrently redeeming the shares of the acquired fund due to, for example, changes in market

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[703] Our analysis is limited by data availability. In particular, we only have monthly data on acquiring funds' holdings and our sample period is primarily a stable period of rising market prices (with the exception of the March to July 2020 period of market stress). Any effects of the redemption limit would be more pronounced during periods of market stress. *See* also 2018 FOF Proposing Release, *supra* footnote 6, at n.125 and accompanying text for similar statistics using data from Morningstar Holdings. Some commenters argued that the low frequency of large-scale redemptions suggests that the redemption limit is unnecessary because funds do not engage frequently in large-scale redemptions that would raise undue influence concerns. *See*, *e.g.*, Dechert Comment Letter.

conditions or if the acquiring fund held more than 25% of the shares of an affiliated acquired fund.[704]

Various commenters provided statistics showing that the redemption limit would be frequently binding.[705] We summarize those statistics in the table below.

Commenter	Sample period for number of funds or instances exceeding redemption limit	Number of acquiring funds holding > 3% of at least one acquired fund's outstanding shares	Number of acquiring funds or instances of redemptions > 3% limit within a 30-day period
Nationwide[706]	January 1, 2016 – December 31, 2018	32 acquiring funds	all 32 acquiring funds in at least one instance and some on as many as four separate instances
ICI[707]	2016 – 2018	516 acquiring funds with $1.8 trillion in assets under management	228 acquiring funds in 1,399 instances[708]
John Hancock[709]	January 1, 2016 – December 31, 2018	-	among all funds sponsored by commenter, 350 instances
JP Morgan[710]	past 3 years	-	among all commenter funds, more than 100 instances

704 *See*, *e.g.*, Vanguard Comment Letter (stating that "by way of example, Vanguard offers an acquiring fund that would be subject to the Proposed Rule, but not subject to the control condition, that holds approximately 60% of an underlying Vanguard fund. We estimate that it would take approximately 2.5 years for this acquiring fund to fully unwind its investment in the underlying fund, assuming there was no other shareholder activity during the period.").

705 A commenter stated that "[f]or three of the five [funds of funds in its group], a majority of each such Fund's investments in Underlying Funds represent more than three-percent of the Underlying Fund's outstanding shares." *See* Russell Comment Letter.

706 *See* Nationwide Comment Letter.

707 The survey sample included 1,359 funds of funds with $2.8 trillion in assets under management, out of which 936 funds of funds with $2 trillion in assets under management would be subject to rule 12d1-4 and be required to comply with the rule's conditions. The reported survey statistics excluded holdings and redemptions of money market funds. *See* ICI Comment Letter.

708 Out of all survey respondents, 394 funds of funds with $1.7 trillion in assets under management were able to provide complete or partial information on their fund redemptions for the period 2016–2018. 122 funds of funds with $147 billion in assets under management were unable to provide any information on their redemptions. Further, some complexes were able to analyze only some of their funds (*e.g.*, larger or affiliated) or were able to analyze a shorter time frame (*e.g.*, a quarter rather than three years).

709 *See* John Hancock Comment Letter.

710 *See* JP Morgan Comment Letter.

TRP[711]	2016 – 2018	-	for a subset of commenter's funds, 6 acquiring funds in 17 instances[712]
MFS[713]	January 1, 2016 – March 31, 2019	-	for one surveyed commenter fund, in 25% of the months surveyed
Voya[714]	2016 – 2018	-	among all commenter funds, 13 acquiring funds in 64 instances
Fidelity[715]	2016 – 2018	-	for one of the commenter fund of funds categories consisting 14 acquiring funds, in 149 instances[716]
Allianz[717]	since December 2016	-	at least 7 out of the 13 acquiring funds in the commenter's fund complex at least once, and most on a number of occasions
SIFMA[718]	January 1, 2018 – March 1, 2019	223 out of 655 surveyed acquiring funds[719]	over 500 of the acquiring funds sponsored by the survey respondents[720]
Morningstar[721]	-	1,591 acquiring funds with $1 billion in assets	-

711 *See* TRP Comment Letter.

712 Statistics exclude redemptions from affiliated money market funds.

713 *See* MFS Comment Letter.

714 *See* Voya Comment Letter.

715 *See* Fidelity Comment Letter.

716 Approximately one third of the 149 redemptions were out of unaffiliated acquired funds (non-ETFs). During the same period, another of the commenter's fund of funds categories redeemed more than 3% of an affiliated fund's total outstanding shares in a rolling 30-day period a total of 172 times. All redemptions were out of affiliated open-end funds.

717 *See* Allianz Comment Letter.

718 *See* SIFMA AMG Comment Letter.

719 For purposes of this survey, a fund of funds is a fund that invests substantially all of its assets (*i.e.*, > 85% of fund assets) in shares of other investment companies. In the same survey, there are 59 funds that invest less than 85% of their assets in other funds, and for these funds of funds there have been "dozens of redemptions of more than 3% of an acquired fund's shares during the period from January 1, 2018 through March 1, 2019."

720 The survey included both affiliated and unaffiliated funds of funds arrangements and 90% of the redemptions occurred in affiliated funds of funds.

721 *See* Morningstar Comment Letter.

Most of the commenters' statistics do not distinguish between fund redemptions in the secondary market, which would not have been subject to the redemption limit, and fund redemptions directly with the acquired fund. We are unable to reconcile our statistics with the statistics provided by commenters because we only have monthly data on fund holdings while commenters' holdings information likely is more granular, and we lack complete information regarding commenters' research design choices (*e.g.*, whether the statistics include money market funds).

Commenters raised a number of issues associated with the proposed redemption limit, some of which we discussed in the 2018 FOF Proposing Release.[722] These concerns included (1) operational or administrative challenges; (2) the redemption limit's potential effects on the acquiring fund's investment objectives and its ability to respond timely to changing economic or market conditions; (3) the impact on competition and innovation; (4) whether funds in the same group of investment companies should be subject to the requirements; (5) concerns relating to liquidity; and (6) the cost of the proposed limits.

We have addressed the issues raised by commenters by not adopting the redemption limit and instead imposing alternative conditions to guard against undue influence.

b. Uniform Voting Conditions for all Funds

We proposed to impose the same voting conditions on all funds. In particular, proposed rule 12d1-4 would have required the same ownership threshold that would trigger the voting condition (*i.e.*, 3% of outstanding voting securities of the acquired fund) and the same manner of voting (*i.e.*, pass-through or mirror voting) for all funds that would be subject to rule 12d1-4.

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722 *See supra* section II.C.2.a for detailed discussion of issues raised by commenters regarding the proposed redemption limit. *See also* 2018 FOF Proposing Release, *supra* footnote 6, at 1325–26 for discussion of costs of the proposed redemption limit.

One advantage of uniform voting conditions would be a less complex rule, which would facilitate rule compliance. Another advantage would be imposing the same conditions on all acquired funds, which would level the playing field across acquired funds because all acquired funds would enjoy the same levels of protection from acquiring funds' undue influence. The disadvantage of such an approach would be that it would not consider the unique characteristics of each fund category.[723] In particular, open end funds and UITs hold shareholder meetings infrequently and are rarely the subject of investor activism, while closed-end funds may be required to hold shareholder meetings annually and historically have been the target of activist investors. Hence, concerns of undue influence may differ across fund categories. For this reason, rule 12d1-4 will impose different voting thresholds with respect to acquired funds that are open-end funds and UITs versus BDCs and registered closed-end funds.[724]

c. Disclosure Requirement

We proposed to require a fund that operates in accordance with rule 12d1-4 to disclose in its registration statement that it is (or at times may be) an acquiring fund for purposes of the rule. The advantage of such a disclosure would be that it would put other funds seeking to operate in accordance with rule 12d1-4 on notice that a fund they seek to acquire is itself an acquiring fund, and thus prevent the creation of complex fund of funds structures. This requirement would impose some ongoing costs on funds to prepare and provide those disclosures. Commenters generally opposed the proposed disclosure requirement, predicting that (i) funds would prophylactically disclose that they may rely upon rule 12d1-4, which would reduce the number of available potential acquired funds; (ii) it would be costly for acquiring

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723 *See supra* footnote 145.

724 *See supra* section II.C.1.b.

funds to monitor continuously the disclosure of potential acquired funds; and (iii) time lags between when an acquired fund decides to operate in accordance with the rule and become an acquiring fund and when it updates its registration statement could cause violations of the rule.[725] Further, commenters suggested that such an approach could reduce the number of funds willing to become acquired funds and create fewer investment opportunities for funds of funds.[726]

As mentioned above, the proposed disclosure requirement was designed to put funds on notice that a fund would be subject to rule 12d1-4 as an acquiring fund. Under rule 12d1-4, this function will be filled by the fund of funds investment agreement, which an acquiring fund and acquired fund must execute before the acquiring fund may invest in the acquired fund in excess of the limits imposed by section 12(d)(1). Since rule 12d1-4 imposes the fund of funds investment agreement condition, it does not include such a disclosure requirement.

VI. Paperwork Reduction Act

A. Introduction

Rule 12d1-4 will result in a new "collection of information" within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[727] In addition, the adoption of rule 12d1-4 will affect the current collection of information burden of rule 0-2 under the Act.[728] The amendments to Form N-CEN also will affect the collection of information burden under that form.[729]

The title for the new collection of information for rule 12d1-4 will be: "Rule 12d1-4 Under the Investment Company Act of 1940, Fund of Funds Arrangements." The titles for the

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[725] *See supra* footnotes 242 and 243.

[726] *See supra* footnote 244.

[727] 44 U.S.C. 3501 through 3521.

[728] 17 CFR 270.0-2.

[729] Form N-CEN [referenced in 17 CFR 274.101] under the Investment Company Act.

existing collections of information are: "Rule 0-2 under the Investment Company Act of 1940, General Requirements of Papers and Applications" (OMB Control No. 3235-0636); and "Form N-CEN" (OMB Control No. 3235-0730). The Commission is submitting these collections of information to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

We published notice soliciting comments on the collection of information requirements in the 2018 FOF Proposing Release and submitted the proposed collections of information to OMB for review and approval in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11.[730] We received one comment on the collection of information requirements.[731]

B. Rule 12d1-4

Rule 12d1-4 will permit certain registered funds and BDCs that satisfy certain conditions to acquire shares of another fund in excess of the limits of section 12(d)(1) of the Act without obtaining an exemptive order from the Commission. These conditions include (1) adherence to certain voting provisions, (2) for most funds, entering into a fund of funds investment agreement, (3) for management companies, certain evaluations and findings that are reported to a fund's board, (4) for UITs, an evaluation by the principal underwriter or depositor, and (5) for separate accounts funding variable insurance contracts, the acquiring fund obtaining a certification by the insurance company offering the separate account. These requirements are collections of

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730 *See* 2018 FOF Proposing Release, *supra* footnote 6. We also published a notice soliciting comments on the collection of information requirements in the 2008 ETF Proposing Release. We similarly did not receive comments on the collection of information requirements. *See id.* at n.339 and accompanying text.

731 *See* Guggenheim Comment Letter (stating that lawyers and accounting personnel would need to be involved with the proposed findings requirement).

information for purposes of the PRA. These are the same collections we identified in the 2018 FOF Proposing Release, with two exceptions based upon changes to the rule from the proposal. We have removed the disclosure requirements that were included in the proposed estimate and added the fund of funds investment agreement element of the collection.

The respondents to rule 12d1-4 will be registered funds or BDCs.[732] The collection of information will be mandatory only for entities that wish to operate in accordance with the new rule. Information provided to the Commission in connection with staff examinations or investigations will be kept confidential subject to the provisions of applicable law.

1. Voting Provisions

Under rule 12d1-4, where an acquiring fund and its advisory group (in the aggregate) hold more than 25% of the outstanding voting securities of an acquired fund that is a registered open-end investment company or registered UIT, the acquiring fund will be required to vote those securities using mirror voting, unless certain exceptions apply.[733] If the acquired fund is a closed-end fund, the acquiring fund and its advisory group must vote its securities using mirror voting if they, in the aggregate, hold more than 10% of the outstanding voting securities, unless certain exceptions apply.[734] We estimate that 450 acquiring funds will be subject to these requirements, 440 of which will be utilizing mirror voting and 10 of which will be utilizing pass-through voting in limited circumstances.[735]

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732 *See supra* footnote 617 for the source of salary data.

733 *See* rule 12d1-4(b)(1)(ii) and (iv). As described above, in mirror voting, the acquiring fund votes the shares it holds in the same proportion as the vote of all other holders. In circumstances where acquiring funds are the only shareholders of an acquired fund, however, pass-through voting may be used.

734 *See* rule 12d1-4(b)(1)(iii) and (iv).

735 450 acquiring funds that will invest in open-end funds or UITs in reliance on rule 12d1-4 and beyond the 25% voting threshold = 4,086 acquiring funds that will invest in other funds in reliance on rule 12d1-4 x 11% of acquiring funds that invest in at least one open-end fund or UIT beyond the 25% voting threshold of the rule. 4,086 acquiring funds that will invest in other funds in reliance on rule 12d1-4 = 5,922

Table 5 summarizes the final PRA estimates for internal and external burdens associated with this requirement. This estimate is as proposed, except that we (1) lowered the relative amount of funds that are expected to use pass-through voting given the changes to that requirement, (2) lowered the amount of funds estimated to be subject to these provisions due to the raised threshold of when pass-through or mirror voting will be required and (3) also lowered the expected number of votes per year based upon updated analysis.[736]

Table 5: Voting Provisions PRA Estimates

	Internal Hour Burden[1]		Wage Rate[2]	Internal Time Costs	Annual External Cost Burden
PROPOSED ESTIMATES FOR MIRROR VOTING					
Update proxy voting policies and disclosures	3 hours	×	$392 (in-house attorney)	$1,176	--
Evaluate other votes and vote accordingly (per vote x 3.6 votes)	3 hours × 3.6 = 10.8 hours	×	$392 (in-house attorney)	$1,176 × 3.6 = $4,233.60	$400 × 3.6 = $1,440
Total burden per fund	13.8 hours			$5,409.60	$1,440
Total number of affected funds	× 793			× 793	× 793
Total proposed burden for mirror voting	**10,943.4 hours**			**$4,289,812.80**	**$1,141,920**

acquiring registered investment companies and BDCs x 69% of acquiring funds that will be subject to rule 12d1-4 as estimated by a commenter (see supra footnote 533 and associated text). This estimate assumes that acquiring funds with current investments in other funds beyond the limits of section 12(d)(1) will be subject to rule 12d1-4 at the same rate as the acquiring funds with current investments in other funds within the limits of section 12(d)(1) following the rule adoption. 5,922 acquiring registered investment companies and BDCs = [4,750 acquiring management companies (*see supra* Table 2 in section V.B.1) + 37 acquiring BDCs (*see supra* footnotes 558 and 559 and accompanying text)] x [14,605 registered investment companies (*see supra* Table 1 in section V.B.1) + 83 BDCs (*see supra* footnotes 554 and 555 and associated text)] / [11,788 management companies (see supra Table 2) + 83 BDCs (*see supra* footnotes 558 and 559 and accompanying text)]. We lack structured data that would allow us to estimate the percentage of acquiring funds that are within the same group of investment companies as the acquired fund or 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, and thus will be subject to the rule's voting condition. To avoid underestimating the costs associated with this aspect of rule 12d1-4, we assume that all 450 acquiring funds will be subject to this rule's conditions. Further, the circumstances of an acquiring fund utilizing pass-through voting in the final rule are limited and may be only for certain investments. *See supra* footnote 621 and accompanying text.

736 The 2018 FOF Proposing Release contemplated that 809 funds would be subject to this requirement based upon a 3% threshold, rather than the 25% and 10% threshold we are adopting. *See* 2018 FOF Proposing Release, *supra* footnote 6, at n.349 and accompanying text. *See also supra* footnotes 735 and 621 and footnotes 569 through 570 and accompanying text (outlining updated voting analysis).

PROPOSED ESTIMATES FOR PASS-THROUGH VOTING					
Update proxy voting policies and disclosures	3 hours	×	$392 (in-house attorney)	$1,176	--
Communicate with shareholders and vote accordingly (per vote x 3.6 votes)	30 hours × 3.6 = 108 hours	×	$392 (in-house attorney)	$11,760 × 3.6 = $42,336.00	$4,000 × 3.6 = $14,400
Total burden per fund	111 hours			$43,512	$14,400
Total number of affected funds	× 16			× 16	× 16
Total proposed burden for pass-through voting	**1,776 hours**			**$696,192**	**$230,400**
FINAL ESTIMATES FOR MIRROR-VOTING					
Update proxy voting policies and disclosures	3 hours	×	$419 (in-house attorney)	$1,257	--
Conduct voting procedure (per vote x 1 vote)	3 hours × 1 = 3 hours	×	$419 (in-house attorney)	$1,257 × 1 = $1,257	$400 × 1 = $400
Total burden per fund	6 hours			$2,514	$400
Total number of affected funds	× 440			× 440	× 440
Total final burden for mirror voting	**2,640 hours**			**$1,106,160**	**$176,000**
FINAL ESTIMATES FOR PASS-THROUGH VOTING					
Update proxy voting policies and disclosures	3 hours	×	$419 (in-house attorney)	$1,257	--
Communicate with shareholders and vote accordingly (per vote x 1 vote)	30 hours × 1 = 30 hours	×	$419 (in-house attorney)	$12,570 × 1 = $12,570	$4,000 × 1 = $4,000
Total burden per fund	33 hours			$12,570	$4,000
Total number of affected funds	× 10			× 10	× 10
Total final burden for pass-through voting	**330 hours**			**$125,700**	**$40,000**
TOTAL ESTIMATED BURDENS FOR VOTING PROVISIONS					
Proposed burden estimates	12,719.4 hours			$4,986,004.80	$1,372,320
Proposed total respondents	809				
Revised burden estimates	2,970 hours			$1,231,860	$216,000
Proposed total respondents	450				

Notes:
1. Includes initial burden estimates annualized over a three-year period.
2. *See* SIFMA Report, *supra* footnote 617.

2. Fund of Funds Investment Agreements

As discussed in section II.C.2.4 above, unless the acquiring fund's adviser acts as the acquired fund's investment adviser, the rule will require that the acquiring fund enter into an agreement containing certain provisions with the acquired fund effective for the duration of the funds' reliance on the rule. Funds subject to this requirement must maintain a copy of these agreements.[737] We estimate that 9,240 fund pairs will be subject to this requirement.[738]

Table 6 summarizes the final PRA estimates for internal and external burdens associated with this requirement. This element of the rule was not included in the proposal.

Table 6: Fund of Funds Investment Agreements PRA Estimates

	Internal Hour Burden[1]		Wage Rate[2]	Internal Time Costs	Annual External Cost Burden
ESTIMATES FOR FUND OF FUNDS INVESTMENT AGREEMENTS					
Negotiating and memorializing agreement	20 hours	×	$444.33 (blended rate for in-house attorney, deputy general counsel, and compliance manager)[3]	$8,886.6	$978
Establishing recordkeeping policies and procedures	3 hours	×	$63 (general clerk)	$189	$1,800
	3 hours	×	$96 (senior computer operator)	$288	
Recordkeeping	6 hours	×	$63 (general clerk)	$378	--
	6 hours	×	$96 (senior computer operator)	$576	
Total burden per fund	38 hours			$10,317.6	$2,778
Total number of affected funds	× 9,240			× 9,240	× 9,240
Total burden	**351,120 hours**			**$95,334,624**	**$25,668,720**

Notes:
1. Includes initial burden estimates annualized over a three-year period.
2. *See* SIFMA Report, *supra* footnote 617.
3. The $444.33 wage rate reflects current estimates of the blended hourly rate for an in-house attorney ($419), deputy general counsel ($602) and compliance manager ($312). $444.33 is based on the following calculation: ($419+$602+$312) / 3 = $444.33.

3. Management Companies – Fund Findings

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737 Rule 12d1-4(b)(2)(iv) and (c).

738 *See supra* footnote 661 and accompanying text.

In cases where the acquiring fund is a management company, rule 12d1-4 will require, prior to the initial acquisition of an acquired fund in reliance on the rule, the acquiring fund's investment adviser to evaluate the complexity of the structure and fees and expenses associated with the acquiring fund's investment in the acquired fund, and find that the acquiring fund's fees and expenses do not duplicate the fees and expenses of the acquired fund. In cases where the acquired fund is a management company, rule 12d1-4 will require, prior to the initial acquisition of the acquired fund in reliance on the rule, 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 and, as part of this finding, the investment adviser must consider at a minimum certain enumerated factors. The rule will further require that each investment adviser report its evaluation, finding, and the basis for its evaluation or finding to the fund's board of directors no later than the next regularly scheduled meeting of the board of directors. The rule also will require the acquiring and acquired funds participating in fund of funds arrangements in accordance with the rule to maintain and preserve a copy of each fund of funds investment agreement that is in effect, or was in effect in the past five years, and a written record of the relevant Fund Findings (and the basis for the Fund Findings) made under the rule.[739] We estimate 6,178 funds will be subject to this requirement.[740]

Table 7 summarizes the final PRA estimates for internal and external burdens associated with this requirement. We have made some changes to the estimate from the proposal based upon changes to the rule as adopted.[741] We increased the number of funds responding to this

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739 Rule 12d1-4(b)(2)(i) and (c).

740 *See supra* footnotes 651 and 646.

741 *See* 2018 FOF Proposing Release, *supra* footnote 6, at nn.365-369 and accompanying text.

collection since the final rule will require both the acquiring and acquired funds to make certain findings under the rule. We have also increased our estimated burdens regarding initial hour and cost burdens due to the increased amount of factors that advisers would need to consider as part of this collection. In response to a commenter,[742] we adjusted our estimates regarding the hours and wage rates to conduct evaluations and the creation, review, and maintenance of written materials. Lastly, we reduced the estimates regarding annual hour burdens, and eliminated the estimate of external annual costs, due to the elimination of the requirement to conduct on-going evaluations.

Table 7: Management Company Findings PRA Estimates

	Initial Internal Burden Hours		Annual Internal Hour Burden		Wage Rate[1]	Internal Time Costs	Initial External Cost Burden	Annual External Cost Burden
PROPOSED ESTIMATES								
Conduct evaluations and creation, review, and maintenance of written materials	15 hours	+	6 hours	×	$352 (compliance attorney)	$7,392	$17,610	$5,870
	10 hours			×	$317 (senior portfolio manager)	$3,170		
	5 hours			×	$511 (chief compliance officer)	$2,555		
			5 hours	×	$61 (general clerk)	$305		
			5 hours	×	$94 (senior computer operator)	$470		
Total burden per fund	30 hours		10 hours			$13,892	$17,610	$11,740
Total number of affected funds	× 3,373		× 3,373			× 3,373	× 3,373	× 3,373
Total proposed burden	**101,190 hours**		**33,730 hours**			**$46,857,716**	**$59,398,530**	**$39,599,020**
FINAL ESTIMATES								
Conduct evaluations and creation, review, and maintenance	20 hours	+	8 hours	×	$293 (blended rate for compliance attorney and senior accountant)[2]	$8,204	$35,220	$0

742 *See* Guggenheim Comment Letter.

of written materials	10 hours		×	$332 (senior portfolio manager)	$3,320		
	5 hours		×	$535 (chief compliance officer)	$2,675		
		5 hours	×	$63 (general clerk)	$315		
		5 hours	×	$96 (senior computer operator)	$480		
Total burden per fund	35 hours	13 hours			$14,994	$35,220	$0
Total number of affected funds	× 6,178	× 6,178			× 6,178	× 6,178	× 6,178
Total final burden	**216,230 hours**	**80,314 hours**			**$92,632,932**	**$217,589,160**	**$0**
TOTAL ESTIMATED BURDENS FOR FUND FINDINGS							
Proposed burden estimates	**101,190 hours**	**33,730 hours**			**$46,857,716**	**$59,398,530**	**$39,599,020**
Proposed total respondents	3,373						
Revised burden estimates	**216,230 hours**	**80,314 hours**			**$92,632,932**	**$217,589,160**	**$0**
Revised total respondents	6,178						

Notes:
1. *See* SIFMA Report, *supra* footnote 617.
2. The $293 wage rate reflects current estimates of the blended hourly rate for a compliance attorney ($368) and senior accountant ($218). $293 is based on the following calculation: ($368+$218) / 2 = $293.

4. UITs – Principal Underwriter or Depositor Evaluations

The rule will require that, in cases where the acquiring fund is a UIT, the UIT's principal underwriter or depositor must evaluate the complexity of the structure associated with the UIT's investment in acquired funds, and find that the UIT's fees and expenses do not duplicate the fees and expenses of the acquired funds that the UIT holds or will hold at the date of deposit. The UIT is also required to keep records of the finding, and any basis for the finding.[743] We estimate 200 funds will be subject to this requirement.[744]

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743 Rule 12d1-4(b)(2)(ii) and (c).

744 *See supra* footnote 652.

Table 8 summarizes the final PRA estimates for internal and external burdens associated with this requirement. We decreased the total number of respondents to this item based upon updated analysis as described above. Also, in response to a commenter,[745] we adjusted our estimates regarding the hours and wage rates to conduct evaluations and the creation, review, and maintenance of written materials.[746]

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745 *See* Guggenheim Comment Letter.

746 *See* 2018 FOF Proposing Release, *supra* footnote 6, at nn.373-377 and accompanying text.

Table 8: UIT Evaluation PRA Estimates

	Initial Internal Burden Hours	Annual Internal Hour Burden		Wage Rate[1]	Internal Time Costs	Initial External Cost Burden	Annual External Cost Burden
PROPOSED ESTIMATES							
Conduct evaluations and creation, review, and maintenance of written materials	15 hours		×	$352 (compliance attorney)	$5,280	$2,400	--
	10 hours		×	$317 (senior portfolio manager)	$3,170		
	5 hours		×	$511 (chief compliance officer)	$2,555		
		2.5 hours	×	$61 (general clerk)	$152.50		
		2.5 hours	×	$94 (senior computer operator)	$235		
Total burden per fund	30 hours	5 hours			$11,392.50	$2,400	--
Total number of affected funds	× 306	× 306			× 306	× 306	
Total proposed burden	**9,180 hours**	**1530 hours**			**$3,486,105**	**$734,400**	**–**
FINAL ESTIMATES							
Conduct evaluations and creation, review, and maintenance of written materials	20 hours		×	$293 (blended rate for compliance attorney and senior accountant)[2]	$5,860	$2,400	$0
	10 hours		×	$332 (senior portfolio manager)	$3,320		
	5 hours		×	$535 (chief compliance officer)	$2,675		
		2.5 hours	×	$63 (general clerk)	$157.50		
		2.5 hours	×	$96 (senior computer operator)	$240		
Total burden per fund	35 hours	5 hours			$12,252.50	$2,400	$0
Total number of affected funds	× 200	× 200			× 200	× 200	
Total final burden	**7,000 hours**	**1,000 hours**			**$2,450,500**	**$480,000**	**–**
TOTAL ESTIMATED BURDENS FOR UIT EVALUATIONS							
Proposed burden estimates	9,180 hours	1,530 hours			$3,486,105	$734,400	$

Proposed total respondents	306				
Revised burden estimates	7,000 hours	1,000 hours	$2,450,500	$480,000	$
Revised total respondents	200				

Notes:
1. *See* SIFMA Report, *supra* footnote 617
2. The $293 wage rate reflects current estimates of the blended hourly rate for a compliance attorney ($368) and senior accountant ($218). $293 is based on the following calculation: ($368+$218) / 2 = $293.

5. Separate Accounts Funding Variable Insurance Contracts – Certification

Lastly, the rule will require that, with respect to a separate account funding variable insurance contracts that invests in an acquiring fund, the acquiring fund must obtain a certification from the insurance company offering the separate account. The certification must state that the insurance company 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 Act. The acquiring fund will be required to keep a record of this certification.[747] We estimate 191 funds will be subject to this requirement.[748]

Table 9 summarizes the final PRA estimates for internal and external burdens associated with this requirement. We decreased the total number of respondents to this item based upon updated analysis as described above. Also, we increased the proposed internal hour burden and time costs to account for likely attorney and compliance review of the required certification.[749]

Table 9: Separate Account Certification PRA Estimates

	Internal Hour Burden[1]	Wage Rate[2]	Internal Time Costs	Annual External Cost Burden
PROPOSED ESTIMATES				

747 Rule 12d1-4(b)(2)(iii) and (c).

748 *See supra* footnote 669.

749 *See* 2018 FOF Proposing Release, *supra* footnote 6, at nn.373-377 and accompanying text. The rule will not subject an insurance company to a collection of information as section 26(f)(2)(A) of the Act already requires insurance companies to collect this information.

Obtain certificates and maintain records	1 hour	×	$61 (general clerk)	$61	--
	1 hour	×	$94 (senior computer operator)	$94	
Total burden per fund	2 hours			$155	--
Total number of affected funds	× 663			× 663	
Total proposed burden	**1,326 hours**			**$102,765**	**–**
FINAL ESTIMATES					
Obtain certificates and maintain records	1 hour	×	$419 (in-house attorney)	$419	
	1 hour	×	$71 (compliance clerk)	$71	
	1 hour	×	$63 (general clerk)	$63	--
	1 hour	×	$96 (senior computer operator)	$96	
Total burden per fund	4 hours			$649	--
Total number of affected funds	× 191			× 191	
Total final burden	**764 hours**			**$123,959**	**–**
TOTAL ESTIMATED BURDENS FOR SEPARATE ACCOUNT CERTIFICATION					
Proposed burden estimates	1,326 hours			$102,765	--
Proposed total respondents	663				
Revised burden estimates	764 hours			$123,959	--
Revised total respondents	191				

Notes:
1. Includes initial burden estimates annualized over a three-year period.
2. *See* SIFMA Report, *supra* footnote 617.

6. Rule 12d1-4 Total Estimated Burden

As summarized in Table 10 below, we estimate that the total hour burdens and time costs associated with rule 12d1-4, amortized over three years, would result in an average aggregate annual burden of 578,084 hours and an average aggregate annual monetized time cost of $191,773,875. We also estimate that, amortized over three years, there would be external costs of $243,953,880 associated with this collection of information. Therefore, each fund operating in accordance with the rule will incur an average annual burden of approximately 35.55 hours, at an average annual monetized time cost of approximately $11,794.94, and an external cost of $15,004.24 to comply with it.

Table 10: Rule 12d1-4 Total PRA Estimates

	Internal hour burden	Internal burden time cost	External cost burden
Voting Provisions	2,970 hours	$1,231,860	$216,000
Fund of Funds Investment Agreements	351,120 hours	$95,334,624	$25,668,720
Management Company Findings	216,230 hours	$92,632,932	$217,589,160
UIT Evaluations	7,000 hours	$2,450,500	$480,000
Separate Account Certificates	764 hours	$123,959	$0
Total annual burden	**578,084**	**$191,773,875**	**$243,953,880**
Number of funds	÷ 16,259	÷ 16,259	÷ 16,259
Average annual burden per fund	**35.55 hours**	**$11,794.94**	**$15,004.24**

C. Rule 0-2

Rule 0-2 under the Act, entitled "General Requirements of Papers and Applications," prescribes general instructions for filing an application seeking an order from the Commission under any provision of the Act.[750] Rule 12d1-4 will alleviate some of the burdens associated with rule 0-2 because it will reduce the number of entities that require exemptive relief in order to operate.

Table 11 summarizes the final PRA estimates for internal and external burdens associated with this requirement. We reduced our estimated burdens from what we proposed because of the intervening adoption of rule 6c-11, which also reduced the number of entities that require exemptive relief in order to operate.[751]

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750 *See* Supporting Statement of Rule 0-2 under the Investment Company Act of 1940, General Requirements of Paper Applications (Mar. 3, 2020) (summarizing how applications are filed with the Commission in accordance with the requirements of rule 0-2), *available at* https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201912-3235-002.

751 We proposed an approximate reduction of one-third from the 2016 approved burdens. *See* 2018 FOF Proposing Release, *supra* footnote 6, at nn.381-386 and accompanying text. In the 2019 ETF Adopting Release, we reduced the 2016 approved burdens by 30%. *See* 2019 ETF Adopting Release, *supra* footnote 25, at nn.691-692 and accompanying text. We are reducing the estimates from the 2019 ETF Adopting Release a further 30% as rule 12d1-4 will reduce a different type of application than those addressed by rule 6c-11.

Table 11: Rule 0-2 PRA Estimates

	Number of Responses	Annual hours	Annual internal time cost	Annual external cost burden
2016 approved inventory	184	5,340	$2,029,200.60	$14,090,000
2018 FOF Proposing Release estimate	122	3,551	$1,349,418	$9,369,850
Approved inventory after rule 6c-11	184	3,738	$1,420,440.42	$9,863,000
	- 0.3	- 0.3	- 0.3	- 0.3
Revised estimate	**129**	**2,617 hours**	**$994,308.29**	**$6,904,100**

D. Form N-CEN

Form N-CEN is a structured form that requires registered funds to provide census-type information to the Commission on an annual basis.[752] We are amending Form N-CEN to require management companies and UITs to report whether they relied on section 12(d)(1)(G) or rule 12d1-4 during the reporting period.[753]

Table 12 summarizes the final PRA estimates for internal and external burdens associated with this requirement. We have adjusted these estimates due to the intervening adoption of rule 6c-11, which also added items to Form N-CEN.[754]

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752 *See* Reporting Modernization Adopting Release, *supra* footnote 56.

753 *See supra* Section III.1.

754 We proposed an increase of 0.1 hours per response. *See* 2018 FOF Proposing Release, *supra* footnote 6, at nn.387-395 and accompanying text. The 2019 ETF Adopting Release also added 0.1 hours, but per ETF, to the estimated burden. *See* 2019 ETF Adopting Release, *supra* footnote 25, at nn.691-692 and accompanying text.

Table 12: Form N-CEN PRA Estimates

	Number of Responses	Annual hours		Wage Rate[1]	Annual internal time cost	Annual external cost burden
2016 approved inventory	3,113	74,425	×	$324 (blended rate of senior programmer and compliance attorneys)	$19,204,128	$2,088,176
2018 FOF Proposing Release estimate	3,038	74,729	×	$335.50 (blended rate of senior programmer and compliance attorneys)	$25,070,000	$2,088,176
Approved inventory after rule 6c-11	3,113	74,598				$2,088,176
		+311.3 (+0.1 hours/response)				
Revised estimate	**3,113**	**74,909.3 hours**	×	**$335.50 (blended rate of senior programmer and compliance attorneys**	**$25,132,070.20**	**$2,088,176**

Notes:
1. *See* SIFMA Report, *supra* footnote 617.

VII. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Analysis ("FRFA") has been prepared in accordance with section 4(a) of the Regulatory Flexibility Act ("RFA").[755] It relates to final rule 12d1-4 and the amendments to Form N-CEN under the Investment Company Act. In connection with the new rule, the Commission is rescinding rule 12d1-2 under the Act and certain exemptive relief that has been granted from sections 12(d)(1)(A), (B), (C), and (G) of the Act. Finally, the Commission is adopting related amendments to rule 12d1-1 under the Act. An Initial Regulatory Flexibility Analysis ("IRFA") was prepared in accordance with the RFA and is included in the 2018 FOF Proposing Release.[756]

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755 5 U.S.C. 603(a).

756 *See* 2018 FOF Proposing Release, at section VIII.

A. Need for and Objectives of the Rule and Form Amendments

As described more fully above, rule 12d1-4 will permit registered funds and BDCs that satisfy certain conditions to acquire shares of another fund in excess of the limits of section 12(d)(1) of the Act without obtaining an exemptive order from the Commission. The rule is designed to streamline and enhance the regulatory framework applicable to fund of funds arrangements. In addition, we are rescinding rule 12d1-2 under the Act and certain exemptive relief that has been granted from sections 12(d)(1)(A), (B), (C), and (G) of the Act to create a more consistent and efficient rules-based regime for the formation and oversight of funds of funds. We also are amending rule 12d1-1 to allow funds that rely on section 12(d)(1)(G) to invest in money market funds that are not part of the same group of investment companies in reliance on that rule. Finally, our amendments to Form N-CEN will allow the Commission to better monitor funds' reliance on rule 12d1-4 and section 12(d)(1)(G), and will assist the Commission with its accounting, auditing, and oversight functions.

All of these requirements are discussed in detail above. The costs and burdens of these requirements on small entities are discussed below as well as above in our Economic Analysis and Paperwork Reduction Act Analysis, which discusses the costs and burdens on all funds.

B. Significant Issues Raised by Public Comments

In the 2018 FOF Proposing Release, we requested comment on every aspect of the IRFA, including the number of small entities that would be affected by the proposed rule and amendments, the existence or nature of the potential impact of the proposals on small entities discussed in the analysis and how to quantify the impact of the proposed rule and amendments. We also requested comment on the broader impact of the proposed rule and amendments on all relevant entities, regardless of size.

We proposed adopting a redemption limit that would prohibit an acquiring fund that acquires more than 3% of an acquired fund's outstanding shares from redeeming, submitting for redemption, or tendering for repurchase more than 3% of an acquired fund's total outstanding shares in any 30-day period.[757] Among the comments received on this topic, one commenter stated that the redemption limit could discourage acquiring funds from gaining exposure to non-traditional asset classes with more volatile in- and out-flows and smaller asset bases, resulting in a less desirable mix of assets being made available to investors.[758] Commenters also stated that this would negatively impact newly launched or small acquired mutual funds.[759] For example, these commenters noted that novel and emerging fund strategies, which would likely exist primarily in smaller funds, would not be as attractive to an acquiring fund as they otherwise would be because of liquidity concerns accompanying the redemption condition.[760] Commenters noted the potential that this provision would affect smaller funds disproportionately since funds of funds would likely migrate out of smaller funds into larger funds in order to dilute their position.[761] Further, commenters noted the possible impact of this provision on smaller funds achieving scalable asset sizes.[762] Finally, some commenters raised administrative and compliance challenges associated with tracking the outstanding voting securities of numerous

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757 *See supra* Section II.C.2.

758 Voya Comment Letter.

759 *See, e.g.*, ICI Comment Letter; Invesco Comment Letter; IDC Comment Letter; Voya Comment Letter; Chamber of Commerce Comment Letter; Guggenheim Comment Letter; Dimensional Comment Letter; Wells Fargo Comment Letter; Capital Group Comment Letter; Schwab Comment Letter; John Hancock Comment Letter; Fidelity Comment Letter; Dechert Comment Letter; MFS Comment Letter; Ropes Comment Letter; IAA Comment Letter; BlackRock Comment Letter; Nationwide Comment Letter.

760 *See, e.g.*, Invesco Comment Letter; Chamber of Commerce Comment Letter.

761 *Id.*

762 *See, e.g.*, Nationwide Comment Letter.

acquired funds.[763] As discussed in more detail above, we are not adopting the proposed redemption limit.

Commenters also noted that codifying certain categories of existing exemptive relief would benefit smaller and midsize fund complexes by relieving them of the cost burden of obtaining an exemptive order.[764]

In addition to not adopting the proposed redemption limit, after consideration of the comments we received on the proposed rule and amendments, we are adopting the rule and amendments with several modifications that are designed to reduce certain operational challenges that commenters identified, while maintaining protections for investors and providing useful disclosures regarding fund of funds arrangements. Revisions to the estimates below also are based on updated figures regarding the number of small entities impacted by the rule and amendments and updated estimated wage rates.

C. Small Entities Subject to the Rule

An investment company is a small entity if, together with other investment companies in the same group of related investment companies, it has net assets of $50 million or less as of the end of its most recent fiscal year.[765] Commission staff estimates that, as of December 2019, there were 46 open-end funds (including 8 ETFs), 30 closed-end funds, 2 UITs, and 14 BDCs that would be considered small entities that may be subject to rule 12d1-4.[766] For the purposes of

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763 *See, e.g.*, Fidelity Comment Letter; Ropes Comment Letter.

764 *See, e.g.,* MFDF Comment Letter.

765 *See* rule 0-10(a) under the Investment Company Act.

766 This estimate is derived an analysis of data obtained from Morningstar Direct as well as data reported to the Commission for the period ending December 31, 2019. There are currently no ETMFs or face-amount certificate companies that would be considered small entities. We believe that no BDCs that are small entities invest in other funds outside the limits of 12(d)(1). *See supra* section V.B.1.

this analysis, we estimate that, of those 92 total entities, 8 entities (1 open-end fund, 5 closed-end funds, and 2 UITs) invest in other funds and thus may be subject to the rule.[767]

D. Projected Board Reporting, Recordkeeping, and Other Compliance Requirements

We are adopting new rule 12d1-4 to streamline and enhance the regulatory framework applicable to fund of funds arrangements, the rescission of rule 12d1-2 and certain exemptive relief, and an amendment to rule 12d1-1 to create a more consistent and efficient rules-based regime for the formation and oversight of fund of funds arrangements. We are also adopting amendments to Form N-CEN to allow the Commission to better monitor funds' reliance on rule 12d1-4 and section 12(d)(1)(G) and assist the Commission with its accounting, auditing, and oversight functions.

Rule 12d1-4 will permit registered funds and BDCs that satisfy certain conditions to acquire shares of another fund in excess of the limits of section 12(d)(1) of the Act without obtaining an exemptive order from the Commission. These conditions include (1) adherence to certain voting provisions, (2) for some funds, entering into a fund of funds investment agreement, (3) for management companies, the adviser making certain evaluations and findings that are reported to the fund's board, (4) for UITs, a finding by the principal underwriter or depositor, and (5) for separate accounts funding variable insurance contracts, the acquiring fund obtaining a certification by the insurance company offering the separate account.[768]

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767 *Id.*

768 We estimate that no separate accounts funding variable insurance contracts would be treated as small entities for purposes of this analysis. *See also* Updated Disclosure Requirements and Summary Prospectus for Variable Annuity and Variable Life Insurance Contracts, Investment Company Act Release No. 33814 (May 1, 2020) [FR 24964 (May 1, 2020)] (noting that the Commission expects that few, if any, separate accounts would be treated as small entities).

To harmonize the overall regulatory structure in view of rule 12d1-4, we are rescinding rule 12d1-2, which would 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. Similarly we are rescinding certain exemptive relief that has been granted from sections 12(d)(1)(A), (B), (C), and (G) of the Act for the same reasons. In addition, we are amending rule 12d1-1 to allow funds relying on section 12(d)(1)(G) to invest in money market funds that are not part of the same group of investment companies in reliance on that rule. Finally, we are amending Form N-CEN to require management companies and UITs to report whether they relied on section 12(d)(1)(G) or rule 12d1-4 during the reporting period.

New rule 12d1-4, the rescission of rule 12d1-2 and certain exemptive relief that has been granted from sections 12(d)(1)(A), (B), (C), and (G) of the Act, and the amendments to rule 12d1-1 and Form N-CEN would change current reporting requirements for small entities that choose to rely on the rule. Entities eligible to rely on rule 12d1-4 are required to comply with the requirements of the rule only if they wish to rely on the rule's exemptions. Additionally, entities that are management companies or UITs and are relying on rule 12d1-4 are required to report this reliance on Form N-CEN. For purposes of this analysis, Commission staff estimates, based on outreach conducted with a variety of funds, that small fund groups will incur approximately the same initial and ongoing costs as large fund groups. As discussed above, we estimate that each entity that relies on rule 12d1-4 (and is subject to rule 12d1-4's voting provision) would incur the following annual time and cost burdens (with initial burdens amortized over the initial three years): (a) 6 internal burden hours and $400 in external costs to satisfy the new voting provisions related to mirror voting and 33 internal burden hours and $4,000 in external costs to

satisfy the new voting provisions related to pass-through voting;[769] (b) 38 internal burden hours and $2,778 in external costs to satisfy the requirement that acquiring fund enter into an agreement containing certain provisions with the acquired fund effective for the duration of the funds' reliance on the rule, if the acquiring fund and the acquired fund do not share the same investment adviser;[770] (c) for management companies, 35 internal burden hours and $35,220 in external costs initially,[771] and in cases where the acquired fund is a management company, 13 internal burden hours and $0 in external costs per year on an on-going basis to satisfy the considerations associated with their Fund Findings;[772] and (d) for UITs, 35 internal burden hours and $2,400 in external costs to satisfy the proposed complex structure and aggregate fees analysis.[773] Furthermore, as discussed above, we estimate that each entity that relies on the new rule would incur an additional annual time burden of 0.1 hours to comply with the amendments to Form N-CEN.[774]

Therefore, in the aggregate, we estimate that small entities would incur an annual internal burden of 570 additional hours and an annual external cost burden of $100,664 to comply with the requirements of rule 12d1-4.[775] Furthermore, in the aggregate, we estimate that small entities

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769 *See supra* Section VI.B.1. For purposes of this analysis, we assume that all small entities will utilize mirror voting. *See also supra* footnote 735 and footnotes 569 through 570 and accompanying text (outlining updated voting analysis).

770 *See supra* Section VI.B.2.

771 *See supra* Section VI.B.3.

772 *Id*.

773 *See supra* Section VI.B.4.

774 *See supra* Section VI.D.

775 This estimate is based on the following calculations:

	Internal hour burden	External cost
Voting Provisions		
Mirror Voting	6 hours	$400

would incur an annual burden of an additional 0.8 hours to comply with the amendments to Form N-CEN.[776]

We do not otherwise expect the proposal to generate significant economic impacts on smaller entities that are disproportionate to the general economic impacts, including compliance costs and burdens, discussed in sections VI and VII above.

E. Agency Action to Minimize Effect on Small Entities

The RFA directs the Commission to consider significant alternatives that would accomplish our stated objectives, while minimizing any significant economic impact on small entities. We considered the following alternatives for small entities in relation to the disclosure, findings, board reporting, and recordkeeping requirements: (i) exempting small entities from some or all of the requirements to rely on rule 12d1-4, or establishing different disclosure or reporting requirements, or different disclosure frequency, for small entities to account for different levels of resources available to small entities; (ii) clarifying, consolidating, or

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Small Entities	x 8	x 8
Total Voting Provisions	48 hours	$3,200
Fund of Funds Investment Agreements	38 hours	$2,778
Small Entities	x 8	x 8
Total Agreements	304 hours	$22,224
Management Company Findings		
Initially (Annualized over a 3 year-period)	11.67 hours	$11,740
Annually	13 hours	$0
Small Entities	x 6	x 6
Total Management Cos.	148	$70,440
UIT Evaluations	35 hours	$2,400
Small Entities	x 2	x 2
Total UITs	70 hours	$4,800
Total annual burden	**570 hours**	**$ 100,664**

[776] This estimate is based on the following calculations: 0.1 hours x 8 small entities = 0.8 hours.

simplifying the compliance requirements under rule 12d1-4 for small entities; and (iii) using performance rather than design standards.

In addition, as discussed above, we proposed a redemption limitation applicable to fund of funds investments in an acquired fund to address concerns that an acquiring fund could threaten large-scale redemptions to unduly influence an acquired fund. In response to concerns raised by comments received on this redemption limit, including comments regarding the significant impact the proposed requirement would have on small entities, we are not adopting the redemption limit as part of rule 12d1-4.

Further, as discussed above, any cost savings to prospective acquiring and acquired funds derived from eliminating the need to apply for an exemptive order likely will be more pronounced for smaller funds because (i) the administrative cost of the exemptive order application process likely does not vary with fund size, and thus may constitute a higher percentage of a smaller fund's assets; and (ii) the same exemptive order can be used by multiple funds within a fund complex, and there may be fewer funds to benefit from an exemptive order within smaller fund complexes.[777]

We do not believe that exempting or establishing different requirements for any subset of funds, including funds that are small entities, from rule 12d1-4, the amendments to rule 12d1-1 and Form N-CEN, or the rescission of rule 12d1-2 would permit us to achieve our stated objectives. Nor do we believe that clarifying, consolidating or simplifying the various aspects of the final rule for small entities would satisfy those objectives. In particular, we do not believe that the interest of investors would be served by these alternatives. We believe that all investors, including investors in entities that are small entities, will benefit from the rule and form

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[777] *See supra* section V.C.1.ii (citing MFDF Comment Letter for a similar argument).

amendments. We believe that this rulemaking strikes the right balance between allowing funds to engage in fund of funds arrangements while protecting such entities from the abuses that Congress sought to curtail in adopting section 12(d)(1). We believe that the new requirements are vital to that balance and important to all investors, irrespective of the size of the entity. Existing fund of funds exemptive orders do not distinguish between small entities and other funds. Finally, we determined to use performance rather than design standards for all funds, regardless of size, because we believe that providing funds with the flexibility to determine how to implement the requirements of the rule allows them the opportunity to tailor these obligations to the facts and circumstances of the entities themselves.

VIII. Statutory Authority

The Commission is adopting new rule 12d1-4 pursuant to the authority set forth in sections 6(c), 12(d)(1)(G) and (J), 17(b) and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-12(d)(1)(G) and (J), 80a-17(b), and 80a-37(a)]. The Commission is adopting amendments to rule 12d1-1 pursuant to the authority set forth in sections 6(c), 12(d)(1)(J), and 38(a) of the Act [15 U.S.C. 80a-6(c), 80a-12(d)(1)(J), 80a-37(a)]. The Commission is adopting an amendment to Form N-CEN under the authority set forth sections 8(b), 30(a), and 38(a) of the Investment Company Act [15 U.S.C. 80a-8(b), 80a-29(a), and 80a-37(a)].

List of Subjects in 17 CFR Parts 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

TEXT OF RULES AND FORM AMENDMENTS

For the reasons set out in the preamble, we are amending Title 17, Chapter II of the Code of Federal Regulations as follows:

PART 270 -- RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The authority citation for part 270 continues to read, in part, as follows:

Authority: 15 U.S.C. 80a-1 *et seq*., 80a-34(d), 80a-37, 80a-39, and Pub. L. 111-203, sec. 939A, 124 Stat. 1376 (2010) unless otherwise noted.

* * * * *

2. Amend section 270.12d1-1 by revising paragraph (a) to read as follows:

§ 270.12d1-1 Exemptions for investments in money market funds.

(a) *Exemptions for acquisition of money market fund shares*. If the conditions of paragraph (b) of this section are satisfied, notwithstanding sections 12(d)(1)(A), 12(d)(1)(B), 12(d)(1)(G), 17(a), and 57 of the Act (15 U.S.C. 80a-12(d)(1)(A), 80a-12(d)(1)(B), 80a-12(d)(1)(G), 80a-17(a), and 80a-56)) and § 270.17d-1:

(1) An investment company (*acquiring fund*) may purchase and redeem shares issued by a money market fund; and

(2) A money market fund, any principal underwriter thereof, and a broker or a dealer may sell or otherwise dispose of shares issued by the money market fund to any acquiring fund.

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§ 270.12d1-2 [Removed and Reserved]

3. Remove and reserve section 270.12d1-2.

4. Section 270.12d1-4 is added to read as follows:

§ 270.12d1-4 Exemptions for investments in certain investment companies.

(a) *Exemptions for acquisition and sale of acquired fund shares*. If the conditions of paragraph (b) of this section are satisfied, notwithstanding sections 12(d)(1)(A), 12(d)(1)(B), 12(d)(1)(C), 17(a), 57(a)(1)-(2), and 57(d)(1)-(2) of the Act (15 U.S.C. 80a 12(d)(1)(A), 80a-12(d)(1)(C), 80a 17(a), 80a-56(a)(1)-(2), and 80a-56(d)(1)-(2)):

(1) A registered investment company (other than a face-amount certificate company) or business development company (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*);

(2) 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; and

(3) An acquiring fund that is an affiliated person of an exchange-traded fund (or who is an affiliated person of such a fund) solely by reason of the circumstances described in § 270.6c-11(b)(3)(i) and (ii), may deposit and receive the exchange-traded fund's baskets, provided that the acquired exchange-traded fund is not otherwise an affiliated person (or affiliated person of an affiliated person) of the acquiring fund.

(b) *Conditions*—(1) *Control*. (i) The acquiring fund and its advisory group will not control (individually or in the aggregate) an acquired fund;

(ii) If the acquiring fund and its advisory group, in the aggregate,

(A) Hold more than 25% of the outstanding voting securities of an acquired fund that is a registered open-end management investment company or registered unit investment trust as a result

of a decrease in the outstanding voting securities of the acquired fund, or

(B) Hold more than 10% of the outstanding voting securities of an acquired fund that is a registered closed-end management investment company or business development company, each of those holders will vote its securities in the same proportion as the vote of all other holders of such securities; provided, however, that in circumstances where all holders of the outstanding voting securities of the acquired fund are required by this section or otherwise under section 12(d)(1) to vote securities of the acquired fund in the same proportion as the vote of all other holders of such securities, the acquiring fund will seek instructions from its security holders with regard to the voting of all proxies with respect to such acquired fund securities and vote such proxies only in accordance with such instructions; and

(iii) The conditions in paragraphs (b)(1)(i) through (ii) of this section do not apply if:

(A) The acquiring fund is in the same group of investment companies as an acquired fund; or

(B) The acquiring fund's investment sub-adviser or any person controlling, controlled by, or under common control with such investment sub-adviser acts as an acquired fund's investment adviser or depositor.

(2) *Findings and agreements*. (i) Management companies.

(A) If the acquiring 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 acquiring fund's investment adviser must evaluate the complexity of the structure and fees and expenses associated with the acquiring fund's investment in the acquired fund, and find that the acquiring fund's fees and expenses do not duplicate the fees and expenses of the acquired fund;

(B) 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:

(*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 investments 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 such redemptions in kind; and

(C) The investment adviser to each acquiring or acquired management company must report its evaluation, finding, and the basis for its evaluations or findings required by paragraphs (b)(2)(i)(A) or (B) of this section, as applicable, to the fund's board of directors, no later than the next regularly scheduled board of directors meeting.

(ii) Unit investment trusts. If the acquiring fund is a unit investment trust (*UIT*) and the date of initial deposit of portfolio securities into the UIT occurs after the effective date of this section, the UIT's principal underwriter or depositor must evaluate the complexity of the structure associated with the UIT's investment in acquired funds and, on or before such date of initial deposit, find that the UIT's fees and expenses do not duplicate the fees and expenses of the acquired funds that the UIT holds or will hold at the date of deposit.

(iii) Separate accounts funding variable insurance contracts. With respect to a separate account funding variable insurance contracts that invests in an acquiring fund, the acquiring fund must obtain a certification from the insurance company offering the separate account that the insurance

company 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 Act (15 U.S.C. 80a-26(f)(2)(A)).

(iv) Fund of funds investment agreement. Unless the acquiring fund's investment adviser acts as the acquired fund's investment adviser and such adviser is not acting as the sub-adviser to either fund, the acquiring fund must enter into an agreement with the acquired fund effective for the duration of the funds' reliance on this section, which must include the following:

(A) Any material terms regarding the acquiring fund's investment in the acquired fund necessary to make the finding required under paragraph (b)(2)(i) through (ii) of this section;

(B) A termination provision whereby either the acquiring fund or acquired fund may terminate the agreement subject to advance written notice no longer than 60 days; and

(C) 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.

(3) *Complex fund structures*. (i) No investment company may rely on section 12(d)(1)(G) of the Act (15 U.S.C. 80a-12(d)(1)(G)) or this section to purchase or otherwise acquire, in excess of the limits in section 12(d)(1)(A) of the Act (15 U.S.C. 80a-12(d)(1)(A)), the outstanding

voting securities of an investment company (a *second-tier fund*) that relies on this section to acquire the securities of an acquired fund, unless the second-tier fund makes investments permitted by paragraph (b)(3)(ii) of this section; and

(ii) 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 percent of the value of the total assets of the acquired fund; provided, however, that the 10 percent limitation of this paragraph shall not apply to investments by the acquired fund in:

(A) Reliance on section 12(d)(1)(E) of the Act (15 U.S.C. 80a-12(d)(1)(E));

(B) Reliance on § 270.12d1-1;

(C) A subsidiary that is wholly-owned and controlled by the acquired fund;

(D) Securities received as a dividend or as a result of a plan of reorganization of a company; or

(E) Securities of another investment company received pursuant to exemptive relief from the Commission to engage in interfund borrowing and lending transactions.

(c) *Recordkeeping*. The acquiring and acquired funds relying upon this section must maintain and preserve for a period of not less than five years, the first two years in an easily accessible place, as applicable:

(1) A copy of each fund of funds investment agreement that is in effect, or at any time within the past five years was in effect, and any amendments thereto;

(2) A written record of the evaluations and findings required by paragraph (b)(2)(i) of this section, and the basis therefor within the past five years;

(3) A written record of the finding required by paragraph (b)(2)(ii) of this section and the basis for such finding; and

(4) The certification from each insurance company required by paragraph (b)(2)(iii) of this section.

(d) *Definitions*. For purposes of this section:

Advisory group means 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.

Baskets has the same meaning as in 17 CFR 270.6c-11(a)(1)..

Exchange-traded fund means a fund or class, the shares of which are listed and traded on a national securities exchange, and that has formed and operates in reliance on § 6c-11 or under an exemptive order granted by the Commission.

Group of investment companies means any two or more registered investment companies or business development companies that hold themselves out to investors as related companies for purposes of investment and investor services.

Private fund means an issuer that would be an investment company under section 3(a) of the Act but for the exclusions from that definition provided for in section 3(c)(1) or section 3(c)(7) of the Act (15 U.S.C. 80a-3(c)(1) or 80a-3(c)(7)).

PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

5. The general authority citation for part 274 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78*l*, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, 80a-29, and Pub. L. 111-203, sec. 939A, 124 Stat. 1376 (2010), unless otherwise noted.

* * * * *

6. Amend Form N-CEN (referenced in §274.101), by:

a. In Part C, revising Item C.7. and adding paragraphs l. and m.; and

b. In Part F, adding Item F.18. and Item F.19.

The revisions and additions read as follows:

Note: The text of Form N-CEN does not and the amendments will not appear in the Code of Federal Regulations.

FORM N-CEN

ANNUAL REPORT FOR REGISTERED INVESTMENT COMPANIES

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Part C. Additional Questions for Management Investment Companies

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Item C.7. **Reliance on certain statutory exemption and rules. Did the Fund rely on the following statutory exemption or any of the rules under the Act during the reporting period? (check all that apply)**

* * *

l. Rule 12d1-4 (17 CFR 270.12d1-4): ___

m. Section 12(d)(1)(G) of the Act (15 USC 80a-12(d)(1)(G)): ___

* * * * *

Part F. Additional Questions for Unit Investment Trusts

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Item F.18. Reliance on rule 12d1-4. Did the Registrant rely on rule 12d1-4 under the Act (17 CFR 270.12d1-2) during the reporting period? [Y/N]

Item F.19. Reliance on section 12(d)(1)(G). Did the Registrant rely on the statutory exception in section 12(d)(1)(G) of the Act (15 USC 80a-12(d)(1)(G)) during the reporting period? [Y/N]

* * * * *

By the Commission.

Dated: October 7, 2020.

Vanessa A. Countryman
Secretary.

[FR Doc. 2020-23355 Filed: 11/18/2020 8:45 am; Publication Date: 11/19/2020]