CARLTON FIELDS

SEC Streamlines Fund of Fund Relief, Requires Life Company 'Certification'

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The SEC has adopted new Rule 12d1-4 under the Investment Company Act and taken other action "to streamline and enhance the regulatory framework applicable to fund of funds (FOF) arrangements." This includes FOFs in which life insurance company separate accounts may invest.

The rule permits certain registered investment companies that satisfy conditions to acquire shares of another fund in excess of the quantitative limits of Section 12(d)(1) of the act without obtaining an exemptive order from the SEC. The conditions include:

- adherence to certain voting restrictions like mirror voting;
- for most funds, entering into a fund of funds investment agreement;
- for management companies, certain evaluations and findings that are reported to a fund's board;
- for unit investment trusts, an evaluation by the principal underwriter or depositor; and
- for separate accounts funding variable insurance contracts, an underlying fund's obtaining a "certification" by the life insurance company sponsoring the separate account regarding the reasonableness of aggregate cost.

The SEC designed the rule to bring order to the current situation where 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."

The SEC justified the rule as balancing:

- shareholder benefits of using fund of funds arrangements as "a convenient way to allocate and diversify their investments through a single, professionally managed portfolio" with

- the downside, "potential for undue influence, complex structures, or duplicative fees."

In adopting the rule, the SEC dropped a proposed condition prohibiting an acquiring fund from redeeming, or tendering for repurchase, more than 3% of an acquired fund's total outstanding shares in any 30-day period.

The SEC also amended Rule 12d1-1, rescinded Rule 12d-2, amended Form N-CEN, and withdrew certain SEC exemptive orders.

The rule imposes a requirement for life insurance companies with unit investment trust separate accounts investing in underlying funds that invest in other funds. In these three-tier FOF structures, an underlying acquired fund must obtain a "certification" from the life insurance company determining that:

- the fees and expenses borne by the separate account, acquiring fund, and acquired fund, in the aggregate,

- are reasonable in relation to the services provided, expenses expected to be incurred, and risks assumed by the life insurance company.

The rule requires most funds to enter into a "fund of funds investment agreement." However, the rule does not require that the agreement include the "certification," although the agreement may do so. The SEC explained that its "general approach [is] not to codify in our rule all of the particularized terms that an agreement must include to reflect the fund of funds arrangement."

The SEC disagreed with commenters that the "certification" was unnecessary or duplicative of existing requirements. The SEC said that Sections 15(c) and 36(b) of the Investment Company Act did not apply to unit investment trusts involved in three-tier FOFs and, in any event, did not apply to the three tiers in the aggregate. The SEC also noted that the SEC's FOF exemptive orders had included "a condition similar to the certification requirement."

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