

Game Changing Fund of Fund Reforms Ahead

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On December 19, 2018, the SEC proposed rescinding most so-called fund of funds (FoF) exemptive orders and Rule 12d1-2 under the Investment Company Act of 1940 (Act) and replacing them with new Rule 12d1-4.1

Some of these reforms may have significant consequences for both fund complexes that offer FoFs and issuers of variable insurance products that include FoFs as investment options. The deadline for comments on the proposal is May 2, 2019.

Proposed Rule 12d1-4

Proposed Rule 12d1-4 would replace the traditional FoF order conditions (such as Board oversight to prevent “undue influence” and limitations on certain fees) with new rule conditions designed to address these issues. Generally, Rule 12d1-4 would:

- prohibit FoFs and their advisory groups from controlling (i.e., owning more than 25 percent of) an acquired fund, subject to certain exceptions;
- require “pass-through” or “echo voting” if the FoF owns more than 3 percent of the acquired fund, subject to certain exceptions;
(The above control and voting conditions would not apply if the FoF is in the same group of investment companies as the acquired fund or if the FoF’s subadviser or its control affiliate is the adviser or depositor of the acquired fund.)
- generally prohibit a FoF from redeeming more than 3 percent of an acquired fund’s total outstanding shares in any 30-day period (the “3 Percent Redemption Restriction”);
- require the FoF’s investment adviser to evaluate annually the complexity of the FoF structure and aggregate fees associated with the FoF’s investment in the acquired fund, and find that it is in the best interest of the FoF to invest in the acquired fund. FoFs that sell to separate accounts funding variable insurance products must obtain a certification from the insurer that fees at all levels, in the aggregate, are consistent with the standard under Section 26(f)(2)(A) of the Act; and
- restrict three-tier fund arrangements (subject to exceptions similar to those contained in existing FoF orders).

Several of these conditions may incentivize or require certain FoFs to change their strategies.

Challenges Presented by Rule 12d1-4

The SEC’s historical FoF orders have not included any conditions similar to the proposed 3 Percent Redemption Restriction. The 3 Percent Redemption Restriction could have a variety of negative market effects. It could, for example:

- **incentivize FoFs to invest in larger funds** to avoid becoming a 3 percent owner of any acquired fund (making it more difficult for smaller funds to survive);
- **disadvantage smaller fund complexes** that may be less able to create FoFs that invest in the same group of funds and avoid Rule 12d1-4; and
- **create a “Hotel California” situation** for any FoF (or FoF complex) that owns 100 percent of an acquired fund (either initially or due to redemptions by other investors). A FoF that owns 100 percent of an acquired fund would never be able to redeem all of its shares.

In addition to the above criticisms, the 3 Percent Redemption Restriction could present unique issues for certain transactions. For example, it could take a FoF many months to liquidate a significant position in an acquired fund. A long redemption period could prevent nimble portfolio management and also could delay proposed transactions such as:

- FoF liquidations;
- FoF mergers; and
- variable insurance product substitutions out of a FoF.

Possible Improvements

The SEC could revise its proposal in ways that might improve the functionality of FoF arrangements. These include:

- retaining Rule 12d1-2 and expanding it to cover other non-security financial instruments;
- eliminating the 3 Percent Redemption Restriction where the FoF's adviser or sub-adviser (or control person thereof) acts as the acquired fund's adviser, sub-adviser, or depositor;
- increasing the percentage threshold for unrestricted redemptions;
- waiving redemption restrictions when a FoF's ownership of an acquired fund in excess of the Act's limits is due to redemptions by other investors; or
- retaining existing FoF orders and allowing FoFs the option to either rely on Rule 12d1-4 or a FoF order.

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