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Legal Alert: Fund of funds flexibility – What's important to BDCs and closed-end funds in the SEC's rule proposal, including a request for comments on AFFE

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On December 19, 2018, the US Securities and Exchange Commission (SEC) issued a release (the Release) proposing new rule 12d1-4 (the Proposed Rule) and related amendments to streamline and enhance the regulatory framework that applies to funds that invest in other funds (i.e., "fund of funds" structures).[1] Under specific circumstances, the Proposed Rule would allow a regulated fund, including both registered closed-end funds (CEFs) and business development companies (BDCs), to acquire shares of another regulated fund in excess of the limits currently imposed by section 12(d)(1)(A)[2] of the Investment Company Act of 1940, as amended (the Act), without obtaining exemptive relief from the SEC. In addition, the Release seeks comment on existing Acquired Fund Fees and Expenses (AFFE) disclosure requirements (the AFFE Rule), including whether to exempt BDCs from the AFFE Rule or modify the application of the AFFE Rule to BDCs.

Note that this Legal Alert focuses on those aspects of the Release that are likely to be important to BDCs and CEFs. Most fund of funds that exist today involve a structure where the acquiring or "top tier" fund is an open-end fund. These funds of funds operate pursuant to various exemptive rules and individual fund of fund exemptive orders (Existing Relief). If adopted, the Proposed Rule, related amendments, and, most notably, the rescission of rule 12d1-2 and prior exemptive orders, would alter the way that current funds of funds operate in some significant ways that are not discussed in this Legal Alert.

Scope of the Proposed Rule

The Proposed Rule would permit registered investment companies (including mutual funds, unit investment trusts, CEFs (listed and unlisted), exchange-traded funds and exchange-traded mutual funds) and BDCs to acquire the securities of any other registered investment company or BDC in excess of the limits in section 12(d)(1)(A). Currently, these limits prohibit a registered fund from: (1) acquiring more than 3% of another fund's outstanding voting securities; (2) investing more than 5% of its total assets in any one fund; or (3) investing more than 10% of its total assets in funds generally.

BDCs and CEFs Can Serve as "Top Tier Funds": Significantly, in an expansion of what is permitted under Existing Relief, the Proposed Rule would allow both CEFs and BDCs to serve as the acquiring or "top tier" fund. Despite some prior industry pressure, the Proposed Rule would not allow private funds to act as acquiring funds.

Non-Listed BDCs and CEFs Can Serve as "Underlying Funds": Additionally, in another expansion of Existing Relief, the Proposed Rule would permit the acquisition of both listed BDCs and CEFs (currently permitted under some Existing Relief) and non-listed BDCs and CEFs (not generally permitted under

Existing Relief).

Conditions

BDCs and CEFs intending to rely on the Proposed Rule would need to comply with a number of conditions designed to protect investors from the potential abuses that led to the enactment of section 12(d)(1). While these conditions are similar to the conditions currently contained in Existing Relief, they are not identical.[3]

Control: To address the concern that a fund could exert undue influence over another fund, the Proposed Rule would prohibit an acquiring fund and its "advisory group" from controlling an acquired fund, except in certain limited circumstances. The Act establishes a rebuttable presumption of control with respect to any person or group that directly or indirectly beneficially owns more than 25% of the voting securities of a company controls the company.[4]

To further limit the ability of an acquiring fund to exert influence over an acquired fund, if an acquiring fund owned more than 3% of the outstanding voting securities of any acquired fund, the Proposed Rule would require, except in certain limited circumstances, such acquiring fund when voting the securities of the acquired fund to either: (1) seek voting instructions from its security holders and vote its shares in accordance with their instructions (often referred to as "pass-through voting"); or (2) vote the shares held by it in the same proportion as the vote of all other holders of the acquired fund (often referred to as "mirror voting"). As a result of this restriction, the Proposed Rule could not be relied upon by an activist investor seeking to use one fund to gain control of another unaffiliated fund through voting power.

Limit on Redemptions: To address the concern that an acquiring fund could threaten an acquired fund with large-scale redemptions as a means of exerting control over the acquired fund, the Proposed Rule would prohibit an acquiring fund that holds more than 3% of an acquired fund's total outstanding shares from redeeming or tendering for repurchase more than 3% of the acquired fund's total outstanding shares in any 30-day period.

Fees and Other Considerations: To address the concern that a fund of funds structure would result in duplicative or excessive fees, the Proposed Rule requires an evaluation of the complexity of the fund of funds structure and aggregate fees. Where the acquiring fund is a BDC or CEF, this evaluation would be performed by the fund's investment adviser, who must determine that the investment in the acquired fund is in the best interest of the acquiring fund after performing an evaluation of the aggregate fees associated with the investment in the acquired fund and the complexity of the fund of funds arrangement. Such findings and the basis thereof would need to be reported to the acquiring fund's board of directors before an investment in an acquired fund made in reliance on the Proposed Rule and at least annually thereafter. Note that imposing responsibility for the best interest determination on the investment

adviser, and not the board, is in keeping with the SEC's recent efforts to refocus regulatory requirements imposed on fund boards to an oversight function, rather than day-to-day management responsibilities.

Complex Structures: To limit the ability of funds to use fund of funds arrangements to create overly complex structures, the Proposed Rule generally limits the ability of funds to create three-tier fund of funds structures, subject to certain limited exceptions.

AFFE

Of particular interest to BDCs, the Proposed Rule also requests comments regarding the AFFE Rule. The AFFE Rule requires registered funds that invest in other funds (including BDCs) to include a separate AFFE line item in the "Fees and Expenses" table contained in their SEC disclosure documents. This separate AFFE line item must include the registered fund's pro rata share of the "acquired fund's" expenses (including interest expense), which is then added to the registered fund's overall expense ratio. In approving the AFFE Rule in 2006, the SEC noted its belief that the AFFE Rule would not have "an adverse impact on capital formation." However, this proved inaccurate with respect to investments in BDCs when, in 2014, Standard and Poor's and Russell Investment Group removed BDCs from prominent indices due to concerns cited by their registered fund clients regarding the impact of the AFFE Rule on their overall expense ratios as a result of the inclusion of BDCs.

The Proposed Rule picks up on some of the concerns regarding the inclusion of BDCs within the AFFE Rule. In fact, then SEC Commissioner Kara Stein, in her comments related to the Release, specifically encouraged investors to look closely at this AFFE Rule-related line of questioning.[5] The AFFE Rule-related questions included the following:[6]

1. Has the AFFE disclosure requirement been effective? Why or why not?

2. Do investors understand the AFFE disclosure?

    a. Has the AFFE disclosure requirement helped investors understand the fees and expenses associated with their investment in an acquiring fund? If so, how?

    b. For example, has the AFFE disclosure helped in fund selection or fund comparison?

    c. Are there ways that the SEC could improve the AFFE disclosure to make it consistent with their intent in adopting the AFFE disclosure requirement?

    d. Can the SEC make the disclosure easier to understand or more

comparable across pooled vehicles of the same or different types?

e. Are there additional disclosures (e.g., words, graphics, or pictures) that the SEC should require to clarify how AFFE is calculated, in order to help investors understand the fees and expenses associated with such an investment?

3. For purposes of the AFFE disclosure, the definition of "acquired funds" includes investment companies and private funds. Is AFFE disclosure appropriate for all types of acquired funds or should the SEC exempt certain types of acquired funds from the definition of acquired fund for purposes of AFFE disclosure?

   a. If so, which types of acquired funds should be exempted and why?

   b. Alternatively, are there pooled investment vehicles or other entities with structures similar to investment companies and private funds that are not included in the definition of "acquired fund" but should be? If so, which entities and why?

4. Is AFFE disclosure appropriate for every type of fee and expense of every type of acquired fund or should specific types of acquired fund fees or expenses be excluded from the disclosure? If so, which fees and/or expenses and why?

   a. Some have commented, for example, that expenses of certain funds are operationally distinct and thus do not raise expense duplication concerns. For example, closed-end funds, and particularly BDCs, finance a portion of their portfolios through borrowing, which is not typical for open-end funds, and the interest paid is included in the fund's expense ratio. Would the exclusion of certain fees or expenses affect the way that acquired funds characterize expenses?

   b. Are there concerns, other than expense duplication, that warrant disclosure of acquired fund fees and expenses?

   c. Should the SEC instead require two disclosures: one without such fees and expenses and one with such fees and expenses?

5. Alternatively, should the AFFE disclosure be aligned with the restrictions imposed by Congress on the acquisition limitations imposed by section 12(d)(1)(A)?

   a. For example, should the SEC require AFFE disclosures only for acquiring funds that invest in acquired funds in excess of the limits of section 12(d)(1)(A)?

b. Would such an alternative disclosure allow investors to fully understand the acquiring fund's fees and expenses?

6. Has the AFFE disclosure requirement affected investment or other decisions of acquiring funds? If so, in what ways?

7. Are there ways that the SEC can improve the calculation of AFFE? If so, how should the SEC modify the calculation and why?

    a. For example, acquiring funds that have been in operation for less than a year are required to calculate AFFE using the number of days in the fund's fiscal year. Should the SEC revise the AFFE calculation to reflect the number of days the acquiring fund has been in operation, which the SEC believes would be more accurate?

8. Should AFFE take into account fees and expenses of a fund held by an acquired fund?

These questions soliciting comment create additional momentum in the push to revise the AFFE Rule. On September 4, 2018, the Coalition for Business Development, Apollo Investment Management, L.P. and Ares Capital Management LLC jointly filed an exemptive application requesting the SEC exempt BDCs from the meaning of the term "acquired fund" as it relates to the AFFE Rule.[7] Generally, the requested relief would enable registered investment companies to make investments in an exchange-traded BDC without including the BDC's operating expenses in the registered investment company's fee table. While the exemptive application is still pending, if granted, relief would be subject to the following conditions:

1. The relief is only applicable to investments in BDCs' tradable securities, which are securities issued by a BDC that:

    a. were offered in an offering registered under the Securities Act of 1933;

    b. are subject to issuer reporting requirements under the Securities Exchange Act of 1934 (Exchange Act);

    c. trade on a national securities exchange that has registered with the SEC under section 6 of the Exchange Act; and

    d. are not subject to restrictive agreements with the issuer or other security holders.

2. Acquiring funds that are required to disclose AFFE would need to include disclosure in such fund's prospectus about the fees associated with investing in BDCs. The Acquiring Funds will include the disclosure within the narrative risk disclosure. The disclosure will explain that when an Acquiring

Fund purchases a BDC at its market price, the BDC's trading price reflects its operating expense structure, which in turn will reduce the total return of the Acquiring Fund's investment in the BDC.

In other movement regarding AFFE disclosure, the House Appropriations Committee 2019 fiscal year appropriations bill contained language recommending that the SEC address the AFFE Rule.[8] As a result, the momentum to make changes related to the AFFE Rule is building, and the Proposed Rule presents an additional avenue for the SEC to act on AFFE Rule changes.

Comment Period

Comments on the proposal will be due 90 days after the Proposed Rule is published in the Federal Register. It had not been published as of January 11, 2019.

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[1] https://www.sec.gov/rules/proposed/2018/33-10590.pdf.

[2] 15 USC § 80a-12(d)(1)(A).

[3] The Release notes the SEC's view that private funds are not appropriate beneficiaries of the Propose Rule because they are not registered with the SEC and would not be subject to the reporting requirements proposed under the Proposed Rule. For similar reasons, the Proposed Rule would not include foreign funds.

[4] 15 USC § 80a-2(a)(9).

[5] https://www.sec.gov/news/public-statement/statement-stein-2018-12-19-fund-funds.

[6] Questions relating to AFFE can be found on pages 74-77 of the proposal (https://www.sec.gov/rules/proposed/2018/33-10590.pdf).

[7] https://www.sec.gov/Archives/edgar/data/1449853/000147361218000002/a26449579_12xcsbgexemptive.htm.

[8] Making Appropriations for Fin. Serv. & Gen. Gov't for the Fis. Year Ending Sept. 30, 2019, & for Other Purposes, 115th Cong. (2018).

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