Securities and Exchange Commission

17 CFR Parts 270 and 274

[Release Nos. 33–10590; IC–33329; File No. S7–27–18]

RIN 3235–AM29

Fund of Funds Arrangements

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission (the ''Commission'') is proposing 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 proposed rule, the Commission proposes to rescind rule 12d1–2 under the Act and most exemptive orders granting relief from sections 12(d)(1)(A), (B), (C), and (G) of the Act. Finally, the Commission is proposing related amendments to rule 12d1–1 under the Act and Form N–CEN.

DATES: Comments should be received on or before May 2, 2019.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's internet comment form (*http://www.sec.gov/rules/proposed.shtml*); or
- Send an email to *rule-comments@sec.gov*. Please include File Number S7–27–18 on the subject line.

Paper Comments

- Send paper comments to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549–1090.

All submissions should refer to File Number S7–27–18. This file number should be included on the subject line if email is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's internet website (*http://www.sec.gov/rules/proposed.shtml*). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly.

Studies, memoranda, or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the Commission's website. To ensure direct electronic receipt of such notifications, sign up through the ''Stay Connected'' option at *www.sec.gov* to receive notifications by email.

FOR FURTHER INFORMATION CONTACT: Joel Cavanaugh, John Foley, Senior Counsels; Jacob D. Krawitz, Branch Chief; Melissa S. Gainor, Senior Special Counsel; Brian McLaughlin Johnson, Assistant Director, 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 proposing for public comment 17 CFR 270.12d1–4 (new rule 12d1–4) under the Investment Company Act [15 U.S.C. 80a–1 *et seq.*]; 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.[1]

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I. Background

We are proposing new rule 12d1–4 under the Investment Company Act to streamline and enhance the regulatory framework applicable to fund of funds arrangements.[2] The proposed rule would, under specified circumstances, permit a fund 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.[3] The proposed rule reflects decades of experience with fund of funds arrangements, and would subject funds relying on proposed rule 12d1–4 to a tailored set of conditions that we believe would help protect investors from the harms Congress sought to address by enacting section 12(d)(1) of the Act. As the proposed rule would provide a comprehensive exemption for funds of funds to operate, we also propose to rescind rule 12d1–2 under the Act and individual exemptive orders for certain fund of funds arrangements in order to create a consistent and efficient rules-based regime for the formation and oversight of funds of funds. Finally, in connection with the proposed rescission of rule 12d1–2, we are proposing 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

[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].

[2] For purposes of this release, 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.

[3] We also are proposing amendments to Form N–CEN, a structured form that requires registered funds to provide census-type information to the Commission on an annual basis. *See infra* section IV.

that are not part of the same group of investment companies.[4]

A. Funds' Investments in Other Funds

Funds increasingly invest in other funds as a way to achieve asset allocation, diversification, or other investment objectives. For example, a fund may invest in another fund to gain exposure to a particular market or asset class in an efficient manner.[5] A fund could, for instance, obtain exposure to a foreign market by investing in a country-specific fund rather than investing in the securities of companies listed on an exchange in that country. Funds also may invest in other funds to equitize cash, engage in hedging transactions, or manage risk.

According to staff estimates, almost one half of all registered funds hold investments in other funds.[6] Of those funds investing in other funds, one half invest at least 5% of their assets in other funds, and one quarter hold almost all of their assets (90%) in other funds. The acquired funds most often provide exposures to US equity, international equity, or fixed income asset classes.

Main Street 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.[7] In addition, a fund of funds may provide an investor with exposure to an asset class or fund that may not otherwise be available to that investor.[8]

B. Overview of Section 12(d)(1) Limits

Section 12(d)(1) of the Investment Company Act limits the ability of a fund to invest substantially in shares of another fund.[9] 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.[10]

Section 12(d)(1)(B) of the Act addresses the other side of the transaction by prohibiting a registered open-end fund [11] (and any principal underwriter thereof or broker-dealer registered under 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.[12]

Congress enacted these restrictions because it was concerned about ''pyramiding,'' a practice under which 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.[13] 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). Congress also was concerned about the potential for excessive fees when one fund invested in another,[14] and the formation of overly complex structures that could be confusing to investors.[15] Congress imposed these limits, in part, based on our conclusions in 1966 that fund of funds structures served little or no economic purpose.[16]

Our views and those of Congress regarding fund of funds arrangements have evolved over the years as fund of funds structures have developed to include investor protections and serve purposes that benefit investors.[17] As a

[4] *See infra* section III.

[5] Total net assets in mutual funds that invest primarily in other mutual funds have grown from $469 billion in 2008 to $2.22 trillion in 2017. During this period the number of mutual funds utilizing this arrangement grew from 839 to 1,400. *See* Investment Company Institute, 2018 Investment Company Fact Book (2018) (''2018 ICI Fact Book''), at 256, *available at https://www.ici.org/pdf/2018_factbook.pdf*.

[6] This estimate is derived from an analysis of data obtained from Morningstar Direct for the period ending August 2018. For more data on fund of funds arrangements, *see infra* section VI.

[7] Target-date funds are a common type of fund of funds arrangement that 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).

[8] A fund of funds may invest, for example, in funds or share classes with minimum investment amounts that are higher than some retail investors could afford.

[9] As originally enacted, section 12(d)(1) prohibited a registered fund (and any companies it controlled) from purchasing more than 5% of the outstanding shares of any fund that concentrated its investments in a particular industry, or more than 3% of the shares of any other type of fund. *See* Public Law 76–768, 54 Stat. 789, 809–10 § 12(d)(1) (1940) (codified at 15 U.S.C. 80a–12(d)(1) (1940)). Congress amended section 12(d)(1) to include the current limits in section 12(d)(1)(A) and (B) in 1970.

[10] *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. Pursuant to sections 3(c)(1) and 3(c)(7), private funds are subject to the 3% limitation on investments in registered funds as well. 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 Investment Company Act, but for section 3(c)(1) or 3(c)(7) of that 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.

[11] 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).

[12] *See* 15 U.S.C. 80a–12(d)(1)(B). This prohibition applies to the sale of securities issued by an open-end fund to registered funds and unregistered investment companies. Pursuant to sections 3(c)(1) and 3(c)(7), private funds are subject to the 3% limitation with respect to the sale of any security by any open-end fund to such private fund. 15 U.S.C. 80a–3(c)(1) and 3(c)(7)(D).

[13] *See* Hearing on H.R. 10065 before the Subcomm. of the House Comm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess., 112–14 (1940) (statement of David Schenker); Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, pt. 3, ch. 4, H.R. Doc. No. 136, 77th Cong., 1st Sess., 1031–1041, nn. 58–59 (1941) (''Investment Trust Study''); *id.*, at ch. 7, 2742–50. *See also* Exchange-Traded Funds, Investment Company Act Release No. 28193 (Mar. 11, 2008) [73 FR 14618 (Mar. 18, 2008)] (''2008 Proposing Release''), at n.195 (discussing the legislative history of ''pyramiding schemes''). In some cases, acquired funds directed underwriting and brokerage business to entities affiliated with acquiring fund investors on terms that were unfavorable to acquired fund shareholders.

[14] Controlling persons profited when acquiring fund shareholders paid excessive fees due to duplicative charges at both the acquiring and acquired fund levels. *See* Investment Trust Study, *supra* footnote 13, at ch. 7, 2725–39, 2760–75, 2778–93.

[15] Complicated corporate structures could allow acquiring funds to circumvent investment restrictions and limitations and make it difficult for shareholders of the acquiring fund to understand who controlled the fund or the true value of their investments. *See* Investment Trust Study, *supra* footnote 13, at 2776–77. Acquiring fund shareholders might believe that they owned shares in a fund that invested in equity securities of large companies without understanding that the acquiring fund actually held funds that provided substantial exposure to smaller issuers, foreign currencies, or interest rates. *See id.*, at 2721–95.

[16] *See* 2008 Proposing Release, *supra* footnote 13 (citing legislative history and *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'')). *See also* Fund of Funds Investments, Investment Company Act Release No. 26198 (Oct. 1, 2003) [68 FR 58226 (Oct. 8, 2003)] (''Fund of Funds Proposing Release'') at n.8.

[17] *See* Fund of Funds Investments, Investment Company Act Release No. 27399 (June 20, 2006) [71 FR 36640 (June 27, 2006)] (''Fund of Funds

Continued

result, Congress created statutory exceptions that permit different types of fund of funds arrangements subject to certain conditions.[18] First, section 12(d)(1)(E) of the Act allows an acquiring fund to invest all of its assets in a single fund so that the acquiring fund is, in effect, a conduit through which investors may access the acquired fund.[19] Second, section 12(d)(1)(F) of the Investment Company Act permits a registered fund to take small positions (up to 3% of another fund's securities) in an unlimited number of other funds.[20] Finally, section 12(d)(1)(G) allows a registered 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]

When Congress enacted section 12(d)(1)(G), it also gave the Commission specific authority to permit additional types of fund of funds arrangements as structures evolved. Section 12(d)(1)(J) of the Act allows the Commission to exempt any person, security, or transaction, or any class or classes of transactions, from section 12(d)(1) if the exemption is consistent with the public interest and the protection of investors.[22] A House of Representatives committee report on the amendments urged the Commission to use this exemptive authority ''in a progressive way as the fund of funds concept continues to evolve over time.''[23]

We exercised this exemptive authority in 2006 when we adopted 17 CFR 270.12d1–1 (rule 12d1–1), 17 CFR 270.12d1–2 (rule 12d1–2), and 17 CFR 270.12d1–3 (rule 12d1–3), which were based on relief we previously provided in a number of exemptive orders.[24] 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 otherwise restrict when we found those arrangements to be consistent with the public interest and the protection of investors.[25] 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).[26] Relief from sections 12(d)(1)(A) and (B) also is included in our exemptive orders that allow exchange-traded funds (''ETFs'') and exchange traded managed funds (''ETMFs'') to operate.[27]

This combination of statutory exemptions, Commission rules, and exemptive orders, however, 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 12d1–2 when investing in an acquired fund within the same group of investment companies.[28] Alternatively, it could rely on relief provided by an exemptive order, which would allow it to invest in substantially the same investments, but would require the fund to comply with different conditions.

In order to create a more consistent and efficient regulatory framework for fund of funds arrangements, we are proposing to rescind rule 12d1–2 and many of the exemptive orders we have granted giving relief from sections 12(d)(1)(A), (B), (C), and (G) of the Act.[29] We propose to replace that relief with a comprehensive fund of funds framework under new rule 12d1–4. A comprehensive, streamlined framework would reduce confusion and subject fund of funds arrangements to a tailored set of conditions that would enhance investor protection, while also providing funds with investment flexibility to meet their investment

Adopting Release'') at n.7 and accompanying text; 2008 Proposing Release, *supra* footnote 13.

[18] *See* Fund of Funds Proposing Release, *supra* footnote 16, at n.8 and accompanying text.

[19] *See* 15 U.S.C. 80a–12(d)(1)(E). This section is relied upon by master-feeder fund arrangements, in which one or more funds pool their assets by investing in a single fund with the same investment objective.

[20] *See* 15 U.S.C. 80a–12(d)(1)(F). A fund relying on section 12(d)(1)(F) is restricted in its ability to redeem shares of the acquired fund and is unable to use its voting power to influence the outcome of shareholder votes held by the acquired fund.

[21] *See* 15 U.S.C. 80a–12(d)(1)(G). ''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. 15 U.S.C. 80a–12(d)(1)(G)(ii).

[22] *See* National Securities Markets Improvement Act of 1996 (''NSMIA''), Public Law 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 our authority under section 6(c) of the Act. *See* Vanguard Special Tax-Advanced Retirement Fund, Inc., Investment Company Act Release No. 14361 (Feb. 7, 1985) (order), dissenting opinion of Commissioners Treadway and Peters (concluding that applicants failed to establish an adequate record on which the Commission could find an exemption from section 12(d)(1)(A) to meet the standards of section 6(c) of the Act).

[23] H.R. Rep. No. 622, *supra* footnote 22, at 44–45. The report specifically noted that many fund complexes might not have a sufficient number or variety of fund types to permit a workable fund of funds arrangement under section 12(d)(1)(G) and the Commission should use its exemptive authority so ''the benefits of [funds of] funds are not limited only to investors in the largest fund complexes, but, in appropriate circumstances, are available to investors through a variety of different types and sizes of investment company complexes.'' The report stated that, in exercising its authority, the Commission should consider factors that relate to the protection of investors, including the extent to which a proposed arrangement is subject to conditions that are designed to address conflicts of interest and overreaching by a participant in the arrangement, so as to avoid the abuses that gave rise to the initial adoption of the Investment Company Act's restrictions against funds investing in other funds.

[24] *See* Fund of Funds Adopting Release, *supra* footnote 17. Rule 12d1–1 allows funds to invest in shares of money market funds in excess of the limits of section 12(d)(1). *See infra* section III (discussing the proposed amendment of rule 12d1–1). Rule 12d1–2 provides funds relying on section 12(d)(1)(G) with greater flexibility to invest in other types of securities. *See infra* section III (discussing the proposed rescission of rule 12d1–2). Finally, rule 12d1–3 allows acquiring funds relying on section 12(d)(1)(F) to charge sales loads greater than 1.5%. We did not rescind the exemptive orders that funds had relied upon in connection with these arrangements before we adopted rules 12d1–1, 12d1–2 and 12d1–3.

[25] 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''); Franklin Fund Allocator Series, *et al.,* Investment Company Act Release Nos. 32669 (June 5, 2017) [82 FR 26720 (June 8, 2017)] (notice) and 32722 (July 3, 2017) (order) and related application (''Franklin Fund''). 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.

[26] *See, e.g.,* Schwab, *supra* footnote 25. 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.

[27] ETFs are organized as either open-end funds or UITs and require exemptive relief from certain provisions of the Act to operate. ETFs issue shares that can be bought or sold throughout the day in the secondary market at a market-determined price. *See, e.g.,* IndexIQ ETF Trust, *et al.,* Investment Company Act Release Nos. 33163 (July 19, 2018) [83 FR 35289 (July 25, 2018)] (notice) and 33200 (Aug. 14, 2018) (order) and related application. ETMFs are hybrid structures between mutual funds and ETFs and similarly need relief from the Act to operate. Unlike ETFs, secondary market transactions in ETMFs occur at the next-determined net asset value (''NAV'') plus or minus a market-determined premium or discount that may vary during the trading day. *See, e.g.,* Eaton Vance Management, *et al.,* Investment Company Act Release Nos. 31333 (Nov. 6, 2014) [79 FR 67471 (Nov. 13, 2014)] (notice) and 31361 (Dec. 2, 2014) (order) and related application (''Eaton Vance'').

[28] 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.

[29] We do not propose to rescind exemptive orders providing relief from section 12(d)(1)(A) and (B) of the Act with respect to certain interfund lending arrangements. *See infra* footnote 201 and accompanying text.

objectives in an efficient manner. We believe that the proposed rule would provide investors with the benefits of fund of funds arrangements, while protecting them from the historical abuses described above. We also propose to amend rule 12d1–1 under the Act 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.[30]

In developing this proposal, the Commission considered comments we received in response to a package of new rules and rule amendments focused largely on ETFs proposed in 2008.[31] This proposal also takes into account Commission staff observations of developments in the industry since that time.

II. Proposed Rule 12d1–4

A. Scope of Proposed Rule 12d1–4 and Exemptions From Section 12(d)(1) of the Act

Registered funds and BDCs. Proposed rule 12d1–4 would permit a registered investment company or 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 conditions that are designed to address historical abuses associated with fund of funds arrangements. Accordingly, open-end funds, UITs, closed-end funds (including BDCs), ETFs, and ETMFs could rely on proposed rule 12d1–4 as both acquiring and acquired funds.[32]

Today, an acquiring fund's ability to invest in an acquired fund in excess of the limits in section 12(d)(1) varies significantly based on the type of acquiring fund. The following chart describes the types of fund of funds arrangements that have been permitted under our exemptive orders:

Acquiring fund under exemptive orders	Acquired fund under exemptive orders
Open-end funds	Open-end funds, UITs, ETFs, ETMFs, Listed closed-end funds,[33] Listed BDCs.
UITs	Open-end funds, UITs, ETFs, ETMFs, Listed closed-end funds.
Closed-end funds (listed and unlisted)	ETFs, ETMFs.
BDCs (listed and unlisted)	ETFs.
ETFs[34]	Open-end funds, UITs, ETFs, Listed closed-end funds, Listed BDCs.

Proposed rule 12d1–4 would create a consistent framework for all registered funds and BDCs. The proposed rule would subject fund of funds arrangements to conditions that are tailored to different acquiring fund structures, rather than assessing the merit of a particular fund of funds arrangement on an individual basis. As described in more detail below, we believe that these tailored conditions would serve to protect fund investors at both tiers of a fund of funds arrangement.

The following chart describes the types of fund of funds arrangements that would be permitted under proposed rule 12d1–4:

Acquiring fund under proposed rule 12d1–4	Acquired funds under proposed rule 12d1–4
Open-end funds	Open-end funds.
UITs	UITs.
Closed-end funds (listed and unlisted)	Closed-end funds (listed and unlisted).[35]
BDCs (listed and unlisted)	BDCs (listed and unlisted).
ETFs	ETFs.
ETMFs	ETMFs.

Thus, in addition to the fund of funds arrangements currently allowed by our exemptive orders, the proposed rule would allow open-end funds, UITs, and ETFs to invest in unlisted closed-end funds and unlisted BDCs beyond the limits in section 12(d)(1). Proposed rule 12d1–4 would similarly increase permissible investments for closed-end funds beyond ETFs and ETMFs to allow them to invest in open-end funds, UITs, other closed-end funds, and BDCs, in

[30] Under the proposal, a fund relying on section 12(d)(1)(G) would no longer have the flexibility to: (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. In order to make these investments, the fund would need to comply with proposed rule 12d1–4 (including its conditions). *See infra* section III.

[31] *See* 2008 Proposing Release, *supra* footnote 13. The 2008 Proposing Release, among other things, would have allowed funds to invest in ETFs beyond the section 12(d)(1) statutory limits. Proposed rule 12d1–4 also would allow funds to invest in ETFs, and would allow ETFs to act as acquiring funds, in excess of the limits in section 12(d)(1). As discussed in section V, we propose to rescind the exemptive relief relating to investments in ETFs that has been included in our ETF exemptive orders.

[32] The proposed rule would not be available to face-amount certificate companies. Face-amount certificate companies are registered investment companies which 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, we do not propose to include face-amount certificate companies within the scope of proposed rule 12d1–4 as acquiring funds or acquired funds.

[33] 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'').

[34] We have provided this relief to ETFs that are structured as open-end funds and UITs. *See* Exchange-Traded Funds, Investment Company Act Release No. 33140 (June 28, 2018) [83 FR 37332 (July 31, 2018)] (''2018 ETF Proposing Release'') at nn. 344–46 and accompanying text (describing relief from section 12(d)(1) for investments in ETFs).

[35] Under proposed rule 12d1–4, an acquiring fund could invest in unlisted closed-end funds and BDCs. For example, an acquiring fund could invest in interval funds under the proposed rule, which are closed-end funds that offer to repurchase their shares at periodic intervals pursuant to 17 CFR 270.23c–3 (rule 23c–3 under the Investment Company Act), and are generally unlisted. Based on staff analysis, there were 39 interval funds, representing approximately $21 billion in assets, in 2017.

excess of the section 12(d)(1) limits. Under the proposed rule, BDCs, which currently may only invest in ETFs in excess of the section 12(d)(1) limits, would additionally be permitted to invest in open-end funds, UITs, closed-end funds, other BDCs, and ETMFs. Finally, the proposed rule would allow ETMFs to invest in all registered funds and BDCs.

Expanding permissible fund of funds arrangements would provide funds covered by the rule with flexibility to meet their investment objectives. In addition, we believe that the proposed rule's scope would eliminate unnecessary and potentially confusing distinctions among permissible investments for different types of acquiring funds. The proposed rule also would level the playing field among these entities, allowing each to invest in the same universe of acquired funds in excess of the limits in section 12(d)(1) without obtaining individualized exemptive relief from the Commission. We believe that the universe of permissible fund of funds arrangements generally should not turn on the type of the funds in the arrangement. Instead, we believe that the proposed rule should address differences in fund structures with tailored conditions designed to protect against the abuses historically associated with funds of funds.[36] When conditioned appropriately, expanding the scope of permissible acquiring and acquired funds in the manner described above would create a consistent and streamlined regulatory framework, while addressing investor protection concerns.

For example, we do not believe that expanding the scope of permissible acquiring funds to include BDCs would present investor protection concerns regarding undue influence, duplicative fees, or complex structures that the proposed rule's conditions would not address. A BDC relying on the proposed rule as an acquiring fund also is subject to other limitations on its ability to invest in acquired funds.[37] Similarly, we do not believe that including ETMFs within the scope of the proposed rule would present investor protection concerns that we have not already extensively considered with other investment products. We believe that the proposed rule's conditions appropriately address investor protection concerns underlying section 12(d)(1)(A) with respect to these products.[38]

Further, we believe that the proposed rule's scope of permissible arrangements is appropriately calibrated based on our understanding of these investment products and our experience with conditions similar to the proposed rule's conditions. As noted above, Congress specifically urged the Commission to monitor the evolution of legitimate fund of funds arrangements and permit such arrangements when investors are adequately protected against the abuses that led Congress to enact section 12(d)(1). We believe that the proposed rule's conditions appropriately guard against those abuses, serving to protect investors. More specifically, the proposed rule would limit an acquiring fund's ability to exert undue influence over an acquired fund directly through ownership or indirectly through the threat of large-scale redemptions,[39] would require evaluation of the fees associated with a fund of funds arrangement,[40] and would guard against unduly complex fund of funds structures.[41] Accordingly, we believe that the proposed exemptions from sections 12(d)(1)(A), (B), and (C) are consistent with the public interest and the protection of investors under section 12(d)(1)(J) of the Act.

Private funds. Similar to the 2008 proposal, private funds would not be within the proposed rule's scope of acquiring funds.[42] Several commenters on the 2008 proposal urged us to include private funds within that proposed rule's scope.[43] They argued that the conditions of the 2008 proposed rule would prevent abuses by acquiring private funds in the same way that the conditions would prevent abuses by registered acquiring funds. For example, some commenters stated that the rule's prohibition of control by an acquiring fund and the restrictions on direct redemptions would protect an acquired ETF from being unduly influenced by an acquiring private fund.[44] Some also stated that the risks associated with duplicative fees and overly complex structures are less concerning when the acquiring fund is a private fund, because private fund investors may be better able to understand the complex structure and judge the propriety of the private fund's fees than some investors in other types of acquiring funds.[45] They also argued that private fund investment in ETFs would benefit ETFs by increasing the liquidity of ETF shares and furthering economies of scale, and would benefit private funds by permitting them to invest in specific sectors in an efficient manner.[46]

The proposed rule would not include private funds as acquiring funds because private funds are not registered with the Commission and would not be subject to the reporting requirements that we propose below on Form N–CEN regarding reliance on the proposed rule.[47] Private funds also would not report information regarding their acquired fund holdings on Form N–PORT.[48] In addition, private funds are not subject to recordkeeping requirements under the Investment

[36] In 2008, the proposed relief from section 12(d)(1) was considered within the context of a broader ETF rule proposal and thus was limited to sales of shares of ETFs beyond the limits in section 12(d)(1). That proposal, however, similarly would have permitted all registered funds and BDCs to act as acquiring funds under the rule. *See* 2008 Proposing Release, *supra* footnote 13.

[37] *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).

[38] *See supra* footnote 27.

[39] Proposed rule 12d1–4(b)(1) would prohibit the acquiring fund and its advisory group from controlling (individually or in the aggregate) the acquired fund, with certain exceptions. Proposed rule 12d1–4(b)(2) would limit the amount of acquired fund shares that an acquiring fund may redeem directly from the acquired fund during any thirty-day period. *See infra* section II.C.1–2.

[40] Proposed rule 12d1–4(b)(3). *See infra* section II.C.3.

[41] Proposed rule 12d1–4(b)(4). *See also infra* section II.C.4.

[42] Pursuant to sections 3(c)(1) and 3(c)(7), private funds are subject to the 3% limitation on investments in registered funds in section 12(d)(1)(A)(i). Accordingly, private funds require relief from this section in order to invest in registered funds beyond the limits in section 12(d)(1). *See supra* footnote 10. Because the limitations contained in sections 12(d)(1)(A)(i) and 12(d)(1)(B)(i) referenced in 3(c)(1) and 3(c)(7) only apply to registered funds, private funds can invest in other private funds or unregistered investment companies without limitation.

[43] *See, e.g.,* Comment Letter of Barclays Global Fund Advisors (May 16, 2008) (''BGFA Letter'') (all investment companies subject to section 12(d)(1) should be included within the rule's scope); Comment Letter of Managed Fund Association (May 18, 2017) (''MFA Letter''); Comment Letter of The Bar of the City of New York (May 9, 2008) (''NY Bar Letter''); Comment Letter of State Street Global Advisors (May 19, 2008) (''SSgA Letter'').

[44] *See* MFA Letter; SSgA Letter.

[45] *See* MFA Letter; SSgA Letter.

[46] *See, e.g.,* MFA Letter; NY Bar Letter.

[47] *See infra* section IV. However, Form PF and 17 CFR 275.204(b)–1 (rule 204(b)–1 under the Investment Advisers Act of 1940 (the ''Advisers Act'')) require certain registered investment advisers to private funds to file Form PF to report information about the private funds they manage. *See* Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Act Release No. 3308 (Oct. 31, 2011) [76 FR 71128 (Nov. 16, 2011)].

[48] Form N–PORT requires certain registered investment companies 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'').

Company Act.[49] Even if an acquired fund kept records relating to this arrangement, that alone may not provide an adequate basis for monitoring compliance with the proposed rule's conditions.

Accordingly, we do not propose to include private funds as acquiring funds under the scope of the rule. Given the policy considerations discussed above, we believe it is appropriate for private funds to request relief from sections 12(d)(1)(A) and (B) of the Act through our exemptive application process, and for the Commission to weigh these policy considerations in the context of the facts and circumstances of each particular applicant.[50]

Unregistered investment companies. Unregistered investment companies, such as foreign funds, also are excluded from the scope of proposed rule 12d1–4.[51] We have the same concerns regarding fund of funds arrangements involving unregistered investment companies that we discussed above for private funds.[52] By definition, these investment companies are not registered with the Commission and would not be subject to the reporting requirements that we propose below on Form N–CEN regarding reliance on the proposed rule. Furthermore, unregistered foreign funds' investments in U.S. registered funds, and certain abusive practices that were associated with such investments, were a concern underlying Congress's amendments to section 12(d)(1) in 1970.[53] Those amendments expanded the scope of section 12(d)(1) to include unregistered investment companies.[54] We therefore do not propose to include unregistered investment companies as acquiring funds under the rule. As with private funds, we believe it is appropriate for unregistered investment companies to request relief from sections 12(d)(1)(A) and (B) of the Act through our exemptive application process, and for the Commission to weigh the applicable policy considerations in the context of the facts and circumstances of each particular applicant.[55]

We request comment on the scope of proposed rule 12d1–4:

- Should the exemptive relief under the proposed rule include all registered funds and BDCs within the scope of ''acquired funds'' and ''acquiring funds'' as proposed? Should we define those terms more broadly or more narrowly?
- Should we limit the scope of the proposed rule to track the scope of existing fund of funds exemptive relief? For example, should we exclude closed-end funds and BDCs that are not listed on a national securities exchange from the scope of ''acquired funds'' under the proposed rule, maintaining the status quo for those investments?
- Are there investor protection concerns with including closed-end funds and BDCs that are not listed on a national securities exchange in the scope of the ''acquired funds''? If so, what concerns, and why?
- Would including these unlisted closed-end funds and BDCs in the scope of ''acquired funds'' affect an acquiring fund's liquidity risk management, including acquiring funds subject to rule 22e–4 under the Act? If so, how?
- Should closed-end funds and BDCs be permitted to rely on the rule as acquiring funds only with respect to investments in ETFs and ETMFs or with respect to some other limited subset of acquired funds?
- Should UITs be permitted to invest in BDCs under the proposed rule? Would such an arrangement present any concerns that are not addressed by the proposed rule's conditions?
- Should the scope of proposed rule 12d1–4 include ETMFs as acquiring funds, as proposed? Are there any special concerns we should consider with respect to ETMFs, given that we have less experience with fund of fund arrangements involving these funds?
- Should the proposed rule expressly allow sponsors of UITs to deposit units of existing UITs into portfolios of new UIT series beyond the limits of section 12(d)(1)?[56] If so, why, and should the proposed rule include conditions specifically related to such relief? For example, should the proposed rule expressly require that no sales charges are charged in connection with the deposit of units of the existing UIT in the portfolio of the future UIT? Are there other conditions we should consider?
- Are there additional conditions we should consider for any subset of acquiring funds or acquired funds? Are there any proposed conditions that should apply only to a subset of acquiring funds or acquired funds?
- Should the scope of proposed rule 12d1–4 include private funds as acquiring funds? If so, should private funds be permitted to invest in all types of acquired funds under the rule? Or should they be limited to investments in funds that may be bought and sold on

[49] *See, e.g.,* 17 CFR 270.31a–1 (rule 31a–1) (setting forth certain recordkeeping requirements for registered investment companies). While the records of a private fund to which a registered investment adviser provides investment advice are deemed to be the records of the investment adviser under the Investment Advisers Act of 1940 (the ''Advisers Act''), there is no requirement for the private fund to create these records under the Investment Company Act. *See* section 204(b)(2) of the Investment Advisers Act [15 U.S.C. 80b–4(b)(2)].

[50] To date, our exemptive orders have not permitted private funds to invest in registered funds beyond the limits in section 12(d)(1)(A)(i) of the Act.

[51] *See supra* footnote 10 and accompanying text. We use the term ''foreign fund'' to refer to an ''investment company'' as defined in section 3(a)(1)(A) of the Investment Company 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 Investment Company 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). An unregistered foreign fund, as discussed in this release, may be registered in a foreign jurisdiction, such as under the European Union's directive regarding Undertakings for Collective Investments in Transferable Securities (''UCITS''). A foreign fund may conduct a private U.S. offering in the United States without violating section 7(d) of the Act only 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* 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 (June 22, 2011) [76 FR 39646 (July 6, 2011)] (''Exemptions Release'').

[52] The Commission has taken the position 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* Exemptions Release, *supra* footnote 51 (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)).

[53] The legislative history of the 1970 amendments suggests that Congress primarily intended to address four abusive practices: pyramiding of voting control; undue influence over an acquired fund through the threat of large-scale redemptions; investor confusion caused by complex fund of funds structures; and layering of costs. *See* PPI Report, *supra* footnote 16. With respect to foreign funds as acquiring funds, the PPI Report noted that ''redemptions could be unduly escalated by the instability of certain foreign economies, political upheaval, currency reform, or other factors which are not really relevant to investment in domestic mutual funds.'' *See id* at 318.

[54] *See supra* footnote 9.

[55] To date, our exemptive orders have not permitted unregistered funds to invest in registered funds beyond the limits in section 12(d)(1)(A) of the Act.

[56] In several staff no-action letters, the staff has stated that, based on certain facts and circumstances, it would not recommend that the Commission take any enforcement action under section 12(d)(1)(A) (and other sections of the Act) if the sponsor of a UIT deposits units of existing series in portfolios of futures series of the UIT. *See, e.g.,* Municipal Investment Trust Fund, Staff No-Action Letter (pub. avail. Oct. 25, 1975); The Ohio Company, Staff No-Action Letter (pub. avail. March 14, 1977); First Trust of Insured Municipal Bonds, Staff No-Action Letter (pub. avail. Feb. 25, 1979).

an exchange, such as closed-end funds and ETFs?

- If we permit private funds to rely on the rule as acquiring funds, should the rule include additional conditions designed to address private fund investments? For example, should the rule only be available to a private fund with an SEC-registered investment adviser? Should we also permit private funds with exempt reporting advisers to rely on the rule? How should we treat private funds that are sub-advised for these purposes? Should the rule be available only to a private fund for which an investment adviser provides information on Form ADV? [57] Should we require additional reporting on Form ADV regarding whether a private fund relies on rule 12d1–4?
- Should we allow unregistered investment companies, including foreign funds, to rely on the rule as acquiring funds? If we permit unregistered investment companies to rely on the rule, should we include additional conditions in rule 12d1–4 designed to address an unregistered investment company's investments? If so, what conditions?
- Should we continue to take the interpretive position that foreign funds that make private offerings in the U.S. in reliance on section 3(c)(1) or 3(c)(7) are private funds for purposes of section 12(d)(1)? Alternatively, should we only treat foreign funds that conduct their activities with respect to U.S. investors in compliance with section 3(c)(1) or 3(c)(7) *and* are privately offered outside the United States as private funds for purposes of section 12(d)(1)? For example, should we take the position that a fund that conducts a private U.S. offering in compliance with sections 3(c)(1) or 3(c)(7), but also conducts a public offering in a foreign jurisdiction (*e.g.,* certain UCITS funds),[58] is an investment company, rather than a private fund, solely for purposes of section 12(d)(1)? Should the treatment of foreign funds as private funds differ when the foreign fund is an acquiring fund versus when the foreign fund is an acquired fund? Are there different or greater concerns, particularly regarding duplicative fees and complex structures, if registered funds are permitted to invest in foreign funds in excess of the limits in section 12(d)(1)(A) than there are with domestic private funds or registered funds?
- If we permit private funds or unregistered investment companies to rely on rule 12d1–4, should we require those acquiring funds to make certain filings with the Commission disclosing their reliance on the rule? If so, should we promulgate a new form for those filings, and what information should be required on this form? For example, should we consider requiring these funds to report information to the Commission regarding their amount of holdings in an acquired fund? How frequently should we require these funds to report such information? For example, should we require monthly filings? Should reports be filed more or less frequently? Should those reports be public or non-public? Would any special concerns arise with respect to such a condition? To the extent that a foreign fund is registered in a foreign jurisdiction, should we consider requests for substituted compliance when the foreign fund complies with comparable non-U.S. rules?

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

Proposed rule 12d1–4 would provide exemptive relief from section 17(a) of the Act.[59] Section 17 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.[60] 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.[61]

Absent exemptive relief, 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.[62] 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.[63] Furthermore, in instances where an ETF is an acquired fund, section 17(a) would prohibit 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).[64]

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

[57] Investment advisers register with the Commission by completing Form ADV and filing Parts 1A and 2A of that form with the Commission. Exempt reporting advisers also file reports with the Commission on Form ADV. Form ADV generally requires advisers to private funds to report certain information regarding those funds. *See generally,* Rules Implementing Amendments to Investment Advisers Act of 1940, Investment Advisers Act Release No. 3221 (June 22, 2011) [76 FR 42950 (July 19, 2011)]. *See also* Item 7.B and Section 7.B. of Schedule D of Form ADV.

[58] *See supra* footnote 51.

[59] Proposed rule 12d1–4(a).

[60] 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 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.

[61] *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).

[62] If an acquiring fund holds 5% percent 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, relief from section 17(a) would not be necessary.

[63] As discussed below, the proposed rule would 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. For purposes of this section, we assume that funds in the same group of investment companies are under common control because funds that are not affiliated persons would not require relief from section 17(a). *See* Fund of Funds Adopting Release, *supra* footnote 17.

[64] 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) of the Act to permit these transactions. *See, e.g.,* 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, our 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. Such relief is subject to its own protections. *See* 2018 ETF Proposing Release, *supra* footnote 34. The exemptive orders granted to ETMFs have included similar exemptions from section 17(a). *See* Eaton Vance, *supra* footnote 27.

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. In addition, 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.[65] We believe that the exemptions from section 17(a) set forth in the proposed rule meet the standards set forth in sections 17(b) and 6(c). We believe that the proposed rule's conditions make unlikely the prospect of overreaching by an affiliated fund. For example, the proposed rule's redemption limit would prevent an acquiring fund (including an acquiring fund that is an affiliate of the acquired fund) from threatening to quickly redeem or tender a large volume of acquired fund shares as a means to exert undue influence over an acquired fund.[66]

An acquired fund that is an open-end fund or UIT is further protected from overreaching due to the requirement that all purchasers receive the same price.[67] In the case of a closed-end acquired fund, we similarly believe that the acquired fund's repurchase of its shares would provide little opportunity for the acquiring fund to overreach because all holders would receive the same share price.[68]

In addition, the utility of the proposed rule would be limited if we did not exempt fund of funds arrangements from the affiliated transaction prohibitions in section 17(a). As a practical matter, without an exemption from section 17(a), an acquiring fund would be subject to a 5% limit on investments in acquired funds under proposed rule 12d1–4.[69] Similarly, a fund of funds arrangement involving funds that are part of the same group of investment companies or that have the same investment adviser (or affiliated investment advisers) would not be able to rely on proposed rule 12d1–4 without such an exemption. We also believe that the proposed exemption from section 17(a) is necessary in light of the goals of rule 12d1–4. Existing orders have provided similar exemptive relief from the affiliated transaction provisions in section 17(a) for many years.[70]

We proposed exemptions from section 17(a) in connection with our 2008 proposal, which would have permitted an ETF that is an affiliated person of an acquiring fund to purchase and sell ETF shares to the acquiring fund at NAV.[71] We noted there that we did not believe providing these exemptions would implicate the concerns underlying section 17(a). Commenters that addressed these provisions in the 2008 Proposing Release agreed with the proposed relief under section 17(a).[72] One commenter, in particular, noted that the exemption was appropriate in light of the proposed protections in the rule, which provided little opportunity for the acquiring fund to manage an acquired fund for its own benefit.[73]

We request comment on the affiliated transaction exemptions in proposed rule 12d1–4.

• Do the acquiring funds that currently invest in acquired funds on the basis of the relief provided in our orders typically acquire 5% or more of the acquired fund's outstanding voting securities?

• Is the scope of the proposed exemptions from section 17(a) sufficiently broad to allow funds to use the exemptive relief we propose to grant from sections 12(d)(1)(A)–(C)? Should the scope of the proposed exemptions include transactions on the secondary market? If so, why?

C. Conditions

Consistent with the public interest and the protection of investors, proposed 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 conditions in exemptive orders that the Commission has issued permitting fund of funds arrangements.[74] However, we propose to streamline these conditions to enhance compliance and strengthen investor protections. The proposed rule would establish a comprehensive framework that would subject fund of funds arrangements to a tailored set of conditions that address differences in fund structures.[75] The following table sets forth a general overview of the differences between the conditions under our current exemptive relief and the proposed rule:

[65] 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 SEC. 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).

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

[67] The purchase of open-end fund or UIT shares must be at a price based on the current NAV of the shares which is next-computed after receipt of a tender of an offer to purchase or redeem the shares. *See* section 22(c) of the Act and 17 CFR 270.22c–1 (rule 22c–1). Primary market transactions with an ETF (or an ETMF) would also be done at a price based on NAV. *See* 2018 ETF Proposing Release, *supra* footnote 34; Eaton Vance, *supra* footnote 27.

[68] Closed-end fund shares typically are bought and sold on the secondary market. In cases where closed-end funds engage in repurchase transactions, such as with interval funds, the pricing of the closed-end fund's shares in those transactions are subject to certain rules. *See, e.g.,* rule 23c–3; *see also* section 23(c)(2) of the Act (providing for offers to repurchase closed-end funds to be made only after all holders of securities are given reasonable opportunity to submit tenders); 17 CFR 270.23c–1(a)(6) (rule 23c–1(a)(6)) (requiring repurchase of closed-end fund shares be made at a price not above the market value, if any, or the asset value of such security, whichever is lower, at the time of such purchase); 17 CFR 270.23c–1(a)(9) (rule 23c–1(a)(9)) (requiring that the purchase be made in a manner or on a basis that does not unfairly discriminate against any holders of the class of securities purchased).

[69] Without an exemption from section 17(a), an acquired fund generally could not sell its shares to, or redeem or repurchase those shares from, an affiliated acquiring fund.

[70] *See e.g.,* Schwab, *supra* footnote 25; Franklin Fund, *supra* footnote 25; Innovator ETFs, *supra* footnote 33. We believe that section 12(d)(1)(G) of the Act also implies relief under section 17(a) of the Act with respect to the acquisition or sale of shares of an acquired fund within the same group of investment companies.

[71] *See* 2008 Proposing Release, *supra* footnote 13.

[72] *See* ICI Letter; Comment Letter of Xshares Advisors, LLC (May 20, 2008) (''Xshares Letter'').

[73] *See* ICI Letter.

[74] *See, e.g.,* Schwab, *supra* footnote 25; Franklin Fund, *supra* footnote 25; Innovator ETFs, *supra* footnote 33.

[75] For example, the conditions regarding layering of fees vary based on the structure of acquiring fund. *See infra* section II.C.3.

Concern addressed	Condition under existing exemptive orders	Condition under proposed rule 12d1–4
Undue Influence	Voting conditions (including the point at which the voting condition is triggered) differ based on the type of 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.
	Fund boards must make certain findings and adopt procedures to prevent overreaching and undue 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").	An acquiring fund's ability to quickly redeem or tender a large volume of acquired fund shares is restricted (replacing the requirements for participation agreements and board findings/procedures).
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).	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. Requires an evaluation of the complexity of the fund of funds structure and aggregate fees. Specific considerations vary by acquiring fund structure.
Layering of Fees	Caps sales charges and service fees at limits under current FINRA sales rule (rule 2830) 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. Specific considerations vary by acquiring fund structure.

Other than the differences described in this table, the conditions in proposed rule 12d1–4 are substantially similar to the conditions that have been included in our exemptive orders since 1999.[76] We discuss each of the proposed conditions below.

1. Control

In order to address the concern that a fund could exert undue influence over another fund, proposed rule 12d1–4 prohibits an acquiring fund and its advisory group from controlling, individually or in the aggregate, an acquired fund, except in the circumstances discussed below.[77] This condition generally comports with the conditions of the exemptive relief the Commission has previously issued and our 2008 proposal.[78]

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.[79] 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 one who does not own that amount does not control it.[80] A determination of control depends on the facts and circumstances of the particular situation.[81]

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 to not constitute control over the acquired fund. A fund relying on the proposed rule, 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 existed that 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, that 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.[82]

In assessing control, an acquiring fund's investment in an acquired fund would be aggregated with the investment of the acquiring fund's advisory group. Consistent with past exemptive orders, the proposed rule would not require an acquiring fund to aggregate the ownership of an acquiring fund advisory group with an acquiring fund sub-advisory group.[83] Instead, each of these groups would consider its ownership percentage separately and would be subject to the same voting provisions as discussed below.[84]

[76] *See, e.g.,* Schwab, *supra* footnote 25.

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

[78] *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). *See also* 2008 Proposing Release, *supra* footnote 13 (prohibiting an acquiring fund, any of its investment advisers or depositors, or any company in a control relationship with any of those entities from controlling an ETF, individually or in the aggregate).

[79] 15 U.S.C. 80a–2(a)(9).

[80] *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.

[81] "[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.

[82] 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. *See, e.g.,* In re Investors Mutual, Inc., *et al.,* Investment Company Act Release No. 4595 (May 11, 1966) (Commission opinion), at text accompanying nn.11–14 (*citing* The Chicago Corporation, Investment Company Act Release No. 1203 (Aug. 24, 1948); Transit Investment Corporation, Investment Company Act Release No. 927 (July 31, 1946); In the Matter of the M.A. Hanna Company, Investment Company Act Release No. 265 (Nov. 26, 1941)).

[83] Proposed rule 12d1–4(d) defines "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 proposed rule, an acquiring fund would not combine the entities listed in clause (1) with those listed in clause (2).

[84] *See* proposed rule 12d1–4(b)(1)(ii).

We believe requiring an acquiring fund to aggregate its holdings with its advisory group would prevent a 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. Several commenters on our 2008 proposal, however, urged us to narrow the scope of entities that an acquiring fund would be required to aggregate when determining whether an acquiring fund controls an ETF.[85] These commenters noted that the scope of the 2008 Proposing Release's control prohibition was broader than that of section 12(d)(1)(A), which prohibits only an acquiring fund and companies it controls from acquiring in the aggregate more than 3% of an ETF's shares.[86] They also noted the difficulty of complying with the proposed aggregation requirement, particularly for those funds whose advisers are part of large financial organizations where information barriers may preclude the adviser from knowing positions held, for example, by advisers under common control.[87]

Because the control condition effectively allows an acquiring fund and its advisory group to obtain a significant ownership stake in an acquired fund, we do not believe it is appropriate to limit the affiliates that are subject to this condition as suggested by commenters in 2008. 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 proposed definition of the term ''advisory group.'' Other provisions of the Act and our rules also extend to affiliated persons of an investment adviser.[88] Funds (or the advisers) have experience developing compliance policies and procedures in those circumstances.[89] Finally, we also do not believe that the breadth of the entities that are included within an acquiring fund and its advisory group would limit the usefulness of proposed rule 12d1–4. Instead, the risk of undue influence over an acquired fund would be more effectively addressed by requiring the entities that fall within these definitions to aggregate their holdings in an acquired fund for purposes of the control condition.

In some circumstances, such as net redemptions, an acquiring fund's holdings may trigger the Act's control presumption through no action of its own. 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 a decrease in the outstanding voting securities of the acquired fund, the proposed rule would not require an acquiring fund to dispose of acquired fund shares. An acquiring fund, however, would not be able to rely on the proposed rule to acquire additional securities of the acquired fund when it (along with its advisory group) holds more than 25% of the acquired fund's voting securities.

a. Voting Provisions

The proposed rule would require 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 voting securities of an acquired fund.[90] In these circumstances, the acquiring fund would be required to either: (i) Seek voting instructions from its security holders and vote such proxies in accordance with their instructions (''pass-through voting''); or (ii) vote the shares held by it in the same proportion as the vote of all other holders of the acquired fund (''mirror voting'').[91] This proposed condition is designed to limit the acquiring fund and its advisory group's power to influence the outcome of shareholder votes of the acquired fund.[92]

Our exemptive orders have historically included conditions designed to limit an acquiring fund's ability to influence an acquired fund through voting power. The voting conditions in our exemptive orders, however, have differed based on the type of acquired fund. For example, our orders require an acquiring fund (and any other funds within the advisory group) to vote shares of acquired closed-end funds in the manner required by section 12(d)(1)(E), while non-fund entities within the advisory group are required to use mirror voting.[93] The voting condition in our orders applies whenever the acquiring fund invests in a closed-end fund beyond the limits in section 12(d)(1). For acquired open-end funds or UITs, our exemptive relief has required an acquiring fund (and its advisory group) to 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.[94] Our exemptive orders also include exceptions to the voting conditions when the fund of funds arrangement involves funds within the same group of investment companies as discussed below.

We propose to subject all acquiring funds under proposed rule 12d1–4 that do not fall within the control exceptions discussed below to the same voting condition in order to simplify and streamline this requirement. We believe that this approach would facilitate compliance monitoring for fund groups that have multiple types of acquiring funds. We also believe that requiring acquiring funds to utilize mirror voting or pass-through voting whenever their holdings exceed the statutory limit in section 12(d)(1)(A)(i) is appropriate to protect the acquired fund (and ultimately its investors) from undue influence through shareholder votes. A 3% threshold for the voting condition is particularly important because our

[85] *See, e.g.,* BGFA Letter; Comment Letter of Stradley Ronon Stevens & Young LLP (May 19, 2008) (''Stradley Letter''); ICI Letter; Xshares Letter.

[86] *See, e.g.,* ICI Letter.

[87] *See, e.g.,* Xshares Letter. Section 12(d)(1)(B) prohibits an acquired fund from ''knowingly'' selling or otherwise disposing of a security issued by the acquired fund to any other investment company. Section 12(d)(1)(A) does not include a similar ''knowing'' element.

[88] *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 60 and accompanying text.

[89] *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 Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)] (''Compliance Rule Adopting Release'') (noting that funds or their advisers should have policies and procedures in place to identify affiliated persons and to prevent unlawful transactions with them).

[90] Proposed rule 12d–4(b)(1)(ii). The acquiring fund would be required to follow the prescribed voting procedures only so long as such holdings remain above the 3% holdings threshold. This threshold would be calculated as of the record date for a vote at an annual or special meeting of the holders of the acquired fund's shares.

[91] *See* proposed rule 12d1–4(b)(1)(ii).

[92] *See, e.g.,* Fund of Funds Adopting Release, *supra* footnote 17 (funds relying on section 12(d)(1)(F) of the Act are required to follow the section 12(d)(1)(E)(iii) voting procedures so that ''the [acquiring] fund's adviser would not be able to influence the outcome of shareholder votes in the acquired fund.'').

[93] *See* Innovator ETFs, *supra* footnote 33.

[94] *See, e.g.,* 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''). Our 2008 proposal would have included a similar condition for investments in ETFs. *See* 2008 Proposing Release, *supra* footnote 13.

proposal would allow funds to acquire shares of closed-end funds under proposed rule 12d1–4. Closed-end funds historically have been the target of proxy contests.[95]

Since 1999, our exemptive orders also have included specific voting provisions when an insurance product separate account is part of the acquiring fund advisory group or acquiring fund sub-advisory group.[96] These provisions are designed to comport with the conditions of exemptions the Commission has issued specific to certain insurance product structures.[97] Most insurance product separate accounts, however, are organized as UITs and rely on section 12(d)(1)(E) to invest proceeds from the sale of interests in variable annuity and variable life insurance contracts in shares of a mutual fund.[98] Accordingly, we believe most insurance product separate accounts already comply with the voting provisions set forth in section 12(d)(1)(E)(iii)(aa) of the Act, which we propose to incorporate into rule 12d1–4. We therefore do not believe separate voting conditions are necessary for these products.

b. Exceptions From the Control and Voting Conditions

The proposed rule would include 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 (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.[99] The proposed 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. Based on our experience overseeing fund of funds arrangements, we believe the proposed exceptions 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) from the control and voting conditions.

As noted above, open-end funds and UITs may rely on section 12(d)(1)(G) to invest in an open-end fund or UIT within the same group of investment companies. Our exemptive orders have expanded the relief in section 12(d)(1)(G) to allow open-end funds to invest in open-end funds, UITs, ETFs, listed closed-end funds, and listed BDCs within the same group of investment companies. Proposed rule 12d1–4 would allow registered funds and BDCs to invest in other registered funds and BDCs within the same group of investment companies.

For purposes of rule 12d1–4, we propose to 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.'' [100] This 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 closed-end funds and BDCs are within the scope of the exception.

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 proposed rule 12d1–4 unless they are, in fact, related investment companies. 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 proposed rule.[101] The determination of whether advisers are control affiliates, however, depends on the relevant facts and circumstances.[102]

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 would not be necessary for the acquired funds to include comparable disclosure in their prospectuses or that the acquired funds and acquiring funds be marketed as related companies for all purposes and to all potential investors.[103] Rather, the requirement in the definition of ''group of investment companies'' 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 the funds are holding themselves out to potential investors in the acquiring fund. Disclosure in the acquiring fund's prospectus of the identity of the acquired funds in 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.

Our orders also allow an acquiring fund to invest in an acquired fund when an acquiring fund's sub-adviser (or a control affiliate of the sub-adviser) serves as the primary investment adviser or sponsor to the acquired fund.[104] Proposed rule 12d1–4 would

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[95] Since the mid-1990s, closed-end funds that have traded at a discount to NAV have been the target of proxy contests initiated by large investors in those funds, including other funds. *See, e.g.,* Tom Lauricella, *Proxy Fight at Closed-End Fund Opens Can of Worms for Industry,* The Wall Street Journal (Aug. 9, 2002).

[96] *See, e.g.,* The Ohio National Life Insurance Company, *et al.,* Investment Company Act Release Nos. 30895 (Jan. 28, 2014) [79 FR 6238 (Feb. 3, 2014)] (notice) and 30925 (Feb. 24, 2014) (order) and related application (''Ohio Life''). The exemptive relief granted by orders generally is conditioned on registered separate accounts seeking voting instructions from contract owners and then voting their shares in accordance with the instruction received (and voting shares for which no instruction were received in the same proportion as the shares for which instructions were received). Relief granted to unregistered separate accounts is conditioned on those accounts either mirror voting their shares or voting in the same manner as registered separate accounts. *See id.*

[97] The Commission has granted exemptions from certain rules under the Act to the extent necessary to permit certain insurance product structures—referred to as ''mixed and shared funding.'' These exemptions are subject to conditions, including voting conditions, designed to limit potential material conflicts of interest among the different contract owners. *See, e.g.,* The RBB Fund, Inc., *et al.,* Investment Company Act Release Nos. 31648 (May 27, 2015) (notice) [80 FR 31420 (June 2, 2015)] and 31687 (Jun. 23, 2015) (order) and related application; SunAmerica Series Trust, *et al.,* Investment Company Act Release Nos. 31281 (Oct. 10, 2014) (notice) [79 FR 62473 (Oct. 17, 2014)] and 31331 (Nov. 15, 2014) (order) and related application.

[98] *See* Fund of Funds Proposing Release, *supra* footnote 16.

[99] Proposed rule 12d1–4(b)(1)(iii).

[100] Proposed rule 12d1–4(d).

[101] 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.

[102] *See* 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.

[103] 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 investment companies are holding themselves out as related companies and potentially render the control exception unavailable to the fund of funds arrangement.

[104] *See* Calamos Advisors LLC, *et al.,* Investment Company Act Release Nos. 30628 (July 24, 2013) [78 FR 46381 (July 31, 2013)] (notice) and 30653 (Aug. 20, 2013) (order) and related application. *See also* BGFA Letter (noting that asset allocation funds often retain the advisers of acquired ETFs as sub-advisers and that ''[t]he Commission has previously

similarly except these arrangements from the control and voting conditions.[105] This proposed exception would cover arrangements that may not qualify for the proposed exclusion available to funds within the same group of investment companies under subparagraph (b)(1)(iii)(A) because the acquiring fund and acquired fund do not hold themselves out as related funds for purposes of investment and investor services.[106] We believe that these arrangements do not raise the same concerns regarding undue influence as other types of fund of funds arrangements because of the sub-adviser's duties as a fiduciary to both the acquiring fund and acquired fund.

The proposed rule would subject the fund of funds arrangements within these exclusions to a more limited set of conditions than other fund of funds arrangements relying on the rule. 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.[107] In addition, in cases 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).[108] We believe that the proposed rule's other conditions, such as the redemption condition described below, would mitigate against the risks of undue influence when the arrangement involves funds that have advisers that are control affiliates.

c. Potential Alternatives to Proposed Control Condition

We considered several alternatives to the proposed control condition to address concerns regarding undue influence over an acquired fund, including whether we should set a different limit on investments by an acquiring fund and its advisory group in an acquired fund. For example, we considered whether to propose a condition prohibiting an acquiring fund and its advisory group from acquiring more than 10% of the outstanding voting stock of an acquired fund. This alternative would effectively lower an acquiring fund's potential investment in an acquired fund from 25% to 10% when control is based on ownership.[109] A lower limit could reduce the potential for undue influence and could eliminate the need for additional conditions designed to address these concerns, such as the redemption limit described below. A 10% limit also is consistent with sections 12(d)(1)(B) and 12(d)(1)(C) of the Act, which each include a 10% limit on fund investments in a single acquired fund.

We also considered whether we should narrow the scope of entities that should be assessed for purposes of a 10% limit. For example, the 10% limit in section 12(d)(1)(C) applies to the acquiring fund and other funds advised by the same adviser. If we adopted a similar provision, it would have the benefit of excluding from the calculation members of an advisory group that are not funds.[110] As noted above, non-fund affiliates are not subject to the 12(d)(1) limits, and acquiring funds are required to consider their non-fund affiliates' holdings when assessing whether they control an acquired fund by effect of a condition in our exemptive orders. This approach therefore could lessen compliance burdens for those funds whose advisers are part of large financial organizations.

However, we believe that our proposed restrictions on control, which incorporate the 25% presumption, are appropriate when combined with other conditions set forth in proposed rule 12d1–4. For example, we believe the proposed condition requiring specified voting procedures when the acquiring fund and its advisory group exceed a 3% ownership threshold, and the proposed limit on the acquiring fund's ability to quickly redeem or tender a large volume of acquired fund shares effectively mitigate the influence that an acquiring fund and its advisory group may have on an acquired fund, even if the acquiring fund and its advisory group owns up to 25% of that fund.[111] We believe that a higher ownership limit provides an acquiring fund with the ability to allocate its assets in an efficient and cost-effective manner.[112] Together, we believe that these provisions would limit the ability of the members of an acquiring fund's advisory group to exercise undue influence over an acquired fund.

We request comment on the control and voting conditions in proposed rule 12d1–4.

- Would the proposed control and voting conditions sufficiently protect an acquired fund from the type of coercive behavior on the part of acquiring funds that section 12(d)(1) was intended to prevent? Are there other conditions that we should consider to address the potential for undue influence by an acquiring fund and its controlling persons? Should we consider a lower limit (*e.g.,* 10%) or a higher limit (*e.g.,* 30%) on investments by an acquiring fund and its advisory group in an acquired fund? Would a lower limit unduly restrict fund of funds arrangements?
- Should we require an acquiring fund to aggregate its holdings with its advisory group when assessing control of an acquired fund? Are we correct that funds relying on fund of funds exemptive orders already have established policies and procedures to monitor compliance with the aggregation requirement embedded in the definition of an acquiring fund's ''advisory group?''
- Should we define ''advisory group'' as proposed or are there alternatives that we should consider? For example,

granted exemptive relief relating to this issue on many occasions'').

[105] *See* proposed rule 12d1–4(b)(1)(iii)(B). Proposed rule 12d1–4(b)(1)(iii)(B) would, however, use the term ''depositor'' instead of ''sponsor'' to be consistent with other rules.

[106] Fund of funds arrangements where the acquiring fund's primary adviser served as adviser to the acquired fund typically would be able to qualify as funds within the ''same group of investment companies'' and would not require a separate exception under our orders.

[107] An investment adviser has a fiduciary duty to act in the best interests of a fund it advises. *See* section 36(a) under the Investment Company Act. *See also, e.g., SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U.S. 180 (1963); *Rosenfeld* v. *Black,* 445 F.2d 1337 (2d Cir. 1971) (describing the fiduciary relationship between an investment adviser and a mutual fund); *Brown* v. *Bullock,* 194 F. Supp. 207, 229, 234 (S.D.N.Y.), aff'd, 294 F.2d 415 (2d Cir. 1961) (noting that investment advisers are under a fiduciary duty to manage the investment companies entrusted to their care with a single eye to their best interest, free from any self-dealing); Compliance Rule Adopting Release, *supra* footnote 89, at n.68.

[108] Accordingly, we also propose to except these arrangements from the voting condition in proposed rule 12d1–4(b)(1)(ii). *See* proposed rule 12d1–4(b)(iii).

[109] We also considered whether the 10% limit should be combined with a condition prohibiting an acquiring fund and its advisory group from controlling an acquired fund. This approach would capture certain control relationships that are not based on ownership. As with other questions of control discussed in this section, whether a person is controlling, controlled by, or under common control with the acquiring fund's investment adviser or depositor or the acquiring fund's investment sub-adviser depends on the particular facts and circumstances.

[110] Such a provision also could include funds advised by control affiliates of the adviser to reflect the current structure of advisory firms, which may include multiple entities serving as investment advisers to funds. The proposed exception for funds within the same group of investment companies in proposed rule 12d1–4(b)(1)(iii)(A) would incorporate a similar approach. *See supra* footnote 101 and accompanying text.

[111] *See supra* section II.C.2.

[112] For example, one way to gain efficient and cost effective exposure to a particular index in a target-date or life-cycle fund might be to acquire up to 25% of a fund tracking the index. This allocation may change over the life cycle of the fund.

should we exclude control affiliates of an acquiring fund's investment adviser or depositor from this definition and only include control affiliates of the acquiring fund?

- Should we permit, as proposed, an exception to the control and voting conditions when the acquiring fund and acquired fund are part of the same group of investment companies? Alternatively, should the proposed rule only except an acquiring fund that is part of the same group of investment companies from the control condition? Is this proposed exception to these conditions appropriately tailored? Should we define ''group of investment companies'' as proposed or are there alternative definitions we should consider? Should we include a ''holding out'' requirement as part of the exception? Or should we provide additional guidance regarding how a group of funds sharing a common investment adviser or having investment advisers that are control affiliates could satisfy the ''holding out'' prong of the definition?
- Should we also permit, as proposed, an exception to the control and voting conditions 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? Alternatively, should the proposed rule only except such an acquiring fund from the control condition? Are we correct that the potential for abuse is limited in these circumstances due to generally aligned interests? Are there other conditions we should consider in this circumstance?
- Are there particular kinds of votes to which the proposed voting condition should not apply? For example, should there be an exception to the voting condition for votes on changes in control of an acquired fund's adviser? If an acquiring fund has a large enough investment that is subject to the redemption limits (described below) and is unable to redeem its investment in an acquired fund, would the timing of such a vote allow sufficient time for the acquiring fund to seek investor instructions?
- Should the control and voting exceptions cover funds with advisers that are control affiliates as proposed, or only funds that share the same investment adviser? Are we correct that an adviser to an acquiring fund in these circumstances would not seek to benefit the acquiring fund at the expense of the acquired fund?
- Should we require an acquiring fund to vote in the manner prescribed by section 12(d)(1)(E)(iii)(aa) if the acquiring fund and its advisory group hold more than 3% of an acquired fund's outstanding voting securities? Is there a lower or higher threshold that we should consider? Should that threshold vary depending on the type of acquired fund? For example, should there be a lower or higher threshold for closed-end funds? Should that threshold depend on whether a closed-end fund is listed or not? Why? Are there alternative voting procedures that we should consider? Should we eliminate the optionality in the proposed rule and only allow either pass-through voting or mirror voting?
- Are the voting options in proposed rule 12d1–4 workable? Would the proposed threshold cause operational challenges for voting acquired fund shares? How frequently do acquiring funds use pass-through voting or mirror voting under our exemptive orders? How frequently would acquiring funds use pass-through voting versus mirror voting under the proposed rule?
- Instead of the proposed voting condition, should we codify the voting provisions set forth in our existing exemptive orders? [113]
- Are we correct that insurance product separate accounts already have experience complying with the voting provisions in section 12(d)(1)(E)(iii)(aa)? Should we instead include separate voting provisions for insurance product separate accounts? If so, should we codify the voting provisions for insurance product separate accounts set forth in our exemptive orders? [114]
- Is our proposal to calculate the holdings of an acquired fund for the purposes of the 3% voting threshold as of the record date appropriate? Alternatively, should our proposal be more similar to the requirements of section 12(d)(1)(F) of the Act, which requires section 12(d)(1)(E) voting procedures for ''any security purchased or acquired pursuant'' to that section?
- Would the proposed voting provisions have unintended consequences regarding fund governance? If so, what would those consequences be, and how should we address them?
- To the extent that an 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 a decrease in the outstanding voting securities of an acquired fund, should we provide relief from section 17(a) to allow the acquiring fund and its advisory group to redeem shares of the acquired fund in-kind and thus reduce their holdings of the acquired fund?

2. Redemptions

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. Specifically, proposed rule 12d1–4(b)(2) would prohibit 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.[115]

The proposed redemption limitation is designed to provide a check against the influence that an acquiring fund can have on an acquired fund when it owns a significant percentage of the acquired fund. As discussed in the context of the control condition, we believe it is appropriate to permit funds to purchase up to 25% of an acquired fund 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.[116]

[113] *See supra* footnotes 93–94 and accompanying text (describing the voting conditions included in our orders).

[114] *See supra* footnote 96.

[115] Proposed rule 12d1–4(b)(2). 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 2(a)(32) of the Act (defining redeemable security); 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); and rule 22c–1 (purchases and redemptions of fund shares must be at a price based on the current NAV next computed after receipt of an order to purchase or redeem). Since the proposed condition restricts an acquiring fund's ability to redeem or submit a redemption request, rather than an acquired fund's obligation to honor such redemptions, we do not propose an exemption from section 22(e) of the Act in connection with this condition.

[116] Certain acquiring funds that could rely on proposed rule 12d1–4 could acquire even more than 25% of an acquired fund's outstanding voting securities. *See* proposed rule 12d1–4(b)(1)(iii) (providing exceptions from the control and voting conditions for 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 control affiliate of such sub-adviser acts as the acquired fund's investment adviser or depositor). *See also infra* sections III and V (discussing the proposed rescission of rule 12d1–2 and exemptive orders).

We believe the proposed redemption condition, together with the proposed control and voting conditions, are more protective than certain conditions currently found in our orders and may be objectively tested as part of a fund's compliance program. The conditions in our orders generally require the acquired fund board to make certain findings and 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) limits.[117] 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.[118] Our orders also require the acquiring fund 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. 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).[119] In addition, our exemptive orders require the acquired fund and each unaffiliated acquiring fund to execute a participation agreement.[120]

We believe that the proposed redemption, control, and voting conditions address the same concerns regarding overreaching and undue influence that these exemptive order conditions sought to address, without requiring procedures and related board findings covering particular instances where undue influence and overreaching could exist. Therefore, replacing these conditions with the proposed redemption, control, and voting conditions would lower compliance costs and burdens and enhance investor protection for acquired funds.[121]

We believe the proposed limit is appropriately tailored to reduce the threat of large-scale redemptions. Along with the other conditions we are proposing today, it is designed to prevent an acquiring fund from unduly influencing the acquired fund without the board oversight and monitoring conditions imposed by our orders. At the same time, the redemption limit leaves an acquiring fund the ability to redeem a portion of its investment.[122] Because the threat of large-scale redemptions only exists when an acquiring fund holds a significant amount of an acquired fund, the redemption condition does not apply unless the acquiring fund holds shares of the acquired fund in excess of the 3% limit on the acquisition of an acquired fund's outstanding voting securities under section 12(d)(1)(A)(i) of the Act.[123] It does not apply as a result of the fund exceeding the 5% limit on the total assets of an acquiring fund that may be invested in a single acquired fund under section 12(d)(1)(A)(ii) of the Act or the 10% limit on the total assets of an acquiring fund that may be invested in all acquired funds under section 12(d)(1)(A)(iii) of the Act. In addition, acquiring funds that rely on the proposed rule to invest in funds that are listed on an exchange would be permitted to continue to sell shares in the secondary market without regard to the volume limit.[124] Based on the staff's analysis of redemptions of acquired fund shares, we do not believe that our proposed redemption limit would have a large effect on funds.[125] However, we acknowledge that this condition could have a larger impact during periods of market stress or high volatility.

Section 12(d)(1)(F) of the Act includes a redemption provision, but limits redemptions to only 1% of the acquired fund's total outstanding securities during a 30-day period.[126] However, a fund relying on section 12(d)(1)(F) of the Act only may acquire up to 3% of an acquired fund, whereas proposed rule 12d1–4 would permit an acquiring fund to acquire up to 25% of an acquired fund.[127] We believe a 3% redemption limit, rather than a 1% limit, would have a less significant impact on an acquiring fund's liquidity, particularly if the acquiring fund is not able to trade the acquired fund's shares on the secondary market.[128] The

[117] Our orders generally use the term ''unaffiliated funds'' to refer to acquired funds that are not part of the same group of investment companies as the acquiring fund. For purposes of this discussion of the conditions in our orders that differentiate based on whether the acquired fund is part of the same group of investment companies, we will use the term ''unaffiliated acquired fund''. *See, e.g.,* USCF Advisers, LLC, *et al.,* Investment Company Act Release Nos. 32851 (Oct. 4, 2017) [82 FR 47262 (Oct. 11, 2017) (notice) and 32889 (Oct. 31, 2017) (order) and related application (''USCF Advisers''); Franklin Fund, *supra* footnote 25.

[118] This condition also requires the board to review these transactions on at least an annual basis and to maintain certain records associated with the procedures and affiliated underwritings.

[119] *See, e.g.,* USCF Advisers, *supra* footnote 117.

[120] *See, e.g.,* Schwab, *supra* footnote 25.

[121] We anticipate that fund of funds involving separate accounts will continue to enter into participation agreements as a result of the requirements in their ''mixed and shared funding'' orders. *See supra* footnote 97.

[122] The acquiring fund could redeem shares in multiple transactions within a 30-day period, provided that, taken together, they represent less than 3% of the acquired fund's outstanding shares.

[123] If the section 12(d)(1)(A)(i) limits are exceeded, the acquiring fund could not redeem any shares from the acquired fund beyond the rule's limits until the acquiring fund disposes of shares it acquired in excess of the 3% statutory limit. Once the acquiring fund does not hold any shares in excess of 3%, the acquiring fund could redeem any remaining acquired fund shares it held.

[124] We understand that most acquiring funds purchase ETFs, ETMFs, listed closed-end funds, and listed BDCs in secondary market transactions. In some cases, UITs also may have secondary market trading. Secondary market transactions would not involve redemptions from the acquired fund. However, an acquiring fund might seek to redeem ETF or ETMF shares from an ETF or ETMF in a primary market transaction through one or more authorized participants. When transacting with an ETF or ETMF in the primary market, an acquiring fund would be subject to, among other things, the redemption restrictions discussed herein, which could result in acquiring funds being treated differently than other market participants seeking to engage in primary market transactions with an ETF or ETMF.

[125] *See infra* section VI. From January 2017 to June 2018, 0.16% of the monthly redemptions of unlisted acquired funds exceeded the proposed 3% redemption limit. During that same period, 0.76% of the monthly redemptions of listed acquired funds exceeded the proposed 3% redemption limit. For these purposes, open-end funds and UITs are included in the figures for unlisted acquired funds and ETFs, ETMFs, listed closed-end funds, and listed BDCs are included in the figures for listed acquired funds. We estimate the percentage of fund redemptions that are above the 3% limit in any 30-day period using the quarterly fund holding information in Morningstar Investment Company Holdings database between January 2017 and June 2018, and assuming that the changes in quarterly portfolio holdings occur evenly across the three months in each quarter. Our analysis does not distinguish between changes in holdings as a result of primary and secondary market transactions.

[126] *See* section 12(d)(1)(F)(ii) (providing that no issuer of a security purchased or acquired by a registered investment company pursuant to that section is obligated to redeem such security in an amount exceeding 1% of the issuer's total outstanding securities during any period of less than thirty days).

[127] Acquiring funds could rely on proposed rule 12d1–4 to hold more than 25% of an acquired fund's outstanding voting securities when they are part of the same group of investment companies or when the acquiring fund's sub-adviser (or a control affiliate) acts as the acquired fund's adviser or depositor. Because acquiring funds that fall within the exceptions in rule 12d1–4(b)(1)(iii) are not constrained in their ability to control a fund and could acquire more than 25% of an acquiring fund's outstanding voting securities, we propose to subject these types of acquiring funds to the redemption limitation in proposed rule 12d1–4(b)(2).

[128] An acquiring fund that holds more than 3% of an acquired fund's total outstanding shares should take this limitation into account when classifying this portfolio investment as part of its liquidity risk management program under 17 CFR 270.22e–4 (rule 22e–4 under the Act). *See* Investment Company Liquidity Risk Management Programs, Investment Company Act Release No.

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proposed 3% redemption limit would provide funds and their advisers with greater flexibility to manage a fund's investments, while continuing to protect acquired funds from undue influence. In addition, we believe a 3% redemption limit is appropriate for proposed rule 12d1–4 because an acquiring fund that does not seek an exemption from section 12(d)(1)(A) would be able to redeem up to 3% of an acquired fund's total outstanding shares.[129]

We acknowledge that the provision in section 12(d)(1)(F)(ii) is permissive (*i.e.,* acquired funds have the option to limit redemptions in this manner), while the proposed condition in rule 12d1–4 is mandatory. An acquiring fund, however, could influence an acquired fund to eliminate (or never establish) a limit on redemptions if the redemption condition were merely permissive. We therefore propose a mandatory limit on submitting redemptions as a more effective means to mitigate the threat of undue influence than an optional limit.

The Commission proposed stricter redemption limits in 2008, in part because that proposal related to investments in ETFs and we anticipated that most acquiring funds would transact in ETF shares on the secondary market.[130] Under that proposal, an acquiring fund that acquired more than 3% of an ETF's outstanding shares in reliance on rule 12d1–4 would have been prohibited from redeeming any of those shares. Commenters on the 2008 proposal generally supported the proposed condition.[131] One commenter, however, recommended that we modify the redemption condition to provide for volume and time limitations on redemption, rather than rendering particular shares ineligible for redemption.[132]

Under the 2008 proposal, an ETF, its principal underwriter, and a broker or a dealer that relied on the rule to sell the ETF's shares in excess of section 12(d)(1)(B) limits also would have been prohibited from redeeming those shares acquired by another fund that exceeded the 3% limit in section 12(d)(1)(A)(i).[133] In proposing this limit, the Commission acknowledged that it may be difficult for these entities to know whether a redemption order is submitted by such an entity and included a safe harbor for each of those entities if certain conditions were met.[134] Commenters agreed such identification would be difficult and objected to this condition.[135]

Our proposal would not prohibit an acquired fund from redeeming, or its principal underwriter or a broker or dealer from submitting for redemption, shares held by an acquiring fund that exceed the 3% limit in section 12(d)(1)(A)(i). The proposed 30-day limit on redemptions for acquiring funds would reduce the risk of undue influence through the threat of large-scale redemptions, without requiring an acquired fund to track whether a redemption order was submitted by an acquiring fund that holds more than 3% of the acquired fund's shares. Instead, the acquiring fund would need to track its redemptions of acquired fund shares.

We request comment on the proposed redemption condition.

- Should we prohibit, as proposed, 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? Should either of these proposed limits be higher (*e.g.,* 5% or 10%) or lower (*e.g.,* 1%)? Should the period be longer or shorter than 30 days? Should the same limit apply for all types of acquired funds under the rule? How should the rule handle a situation where an acquiring fund initially holds less than 3% of an acquired fund, but comes to hold more than 3% as a result of a decline in assets of the acquired fund? Should this provision of the proposed rule apply to an acquiring fund that ''holds'' more than 3% of an acquired fund's outstanding shares, instead of an acquiring fund that ''acquires'' that amount?
- Should the redemption limit apply to funds that are not traded on the secondary market? Alternatively, should the redemption limit be higher for acquired funds that are not traded on the secondary market? Would eliminating this condition increase the risk that acquiring funds could exert undue influence over acquired funds through the threat of large-scale redemptions? Should there be an exception to the redemption limit for redemptions in kind?
- Should the redemption limit apply to an acquiring fund that is part of the same group of investment companies as the acquired fund? Should the redemption limit apply to an acquiring fund 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? Alternatively, should we except these entities from the redemption condition for the same reasons we propose to except them from the control and voting conditions?
- Are we correct that acquiring funds typically buy and sell ETF shares on the secondary market? Are there instances where acquiring funds transact with an ETF in the primary market through an authorized participant? Would the proposed redemption condition affect the efficiency of the arbitrage mechanism for ETFs? If so, how? For example, would the proposed limitation contribute to premiums or discounts to NAV? How would the proposed redemption limitation affect ETMFs?
- How would the proposed redemption limitation affect acquiring fund's portfolio management? Where an acquiring fund holds more than 3% of the shares of an acquired fund, would the proposed redemption condition unduly impede the ability of acquiring funds to dispose of acquired fund shares, including during periods of market stress or high volatility? Do acquiring funds realize significant

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32315 (Oct. 13, 2016) [81 FR 82142 (Nov. 18, 2016)] (''Liquidity Release'').

[129] An acquiring fund that relies on the statutory exemption to section 12(d)(1)(A) in section 12(d)(1)(G) of the Act, however, may acquire more than 3% of an acquired fund's shares without being subject to any redemption limits if that acquired fund is in the same group of investment companies and structured as an open-end fund or UIT.

[130] *See* 2008 Proposing Release, *supra* footnote 13.

[131] *See, e.g.,* Comment Letter of Independent Directors Council (May 19, 2008) (''IDC Letter'') (''The proposed conditions, particularly the condition limiting the ability of an acquiring fund to redeem ETF shares, offer an efficient means to address the same policy concerns relating to undue influence by an acquiring fund of an ETF that the director-related conditions of the exemptive orders were designed to address.''); Comment Letter of Mutual Fund Directors Forum (May 21, 2008) (''MFDF Letter''); SSgA Letter.

[132] The commenter asserted that it would be difficult to implement a tracking method for particular shares to abide by the redemption prohibition in the 2008 proposal. *See* MFA Letter (suggesting a redemption limit of 1% of an ETF's shares per month during any month the acquiring fund holds more than 3% of the ETF's outstanding shares).

[133] *See* 2008 Proposing Release, *supra* footnote 13, at n.221 and accompanying text. Section 12(d)(1)(B) applies to a registered open-end investment company (and any principal underwriter thereof or broker-dealer).

[134] *See id.* The proposed safe harbor was available for each of those entities if it had: (i) Received a representation from the acquiring fund that none of the ETF's shares the acquiring fund is redeeming includes any shares that it acquired in excess of 3% of the ETF's shares in reliance on the proposed rule; and (ii) no reason to believe that the acquiring fund is redeeming ETF shares that the acquiring fund acquired in excess of 3% of the ETF's shares in reliance on the proposed rule. *See id.*

[135] *See, e.g.,* ICI Letter; Comment Letter of Morgan, Lewis & Bockius LLP (July 28, 2008) (''Morgan Lewis Letter''); BGFA Letter (noting that section 12(d)(1)(B) of the Act (from which this provision would provide an exemption) only prohibits acquired funds from *knowingly* selling shares in excess of the 3% limit in section 12(d)(1)(A)(i)).

benefits from the ability to redeem acquired fund shares in these circumstances? Would the proposed limitation disrupt acquiring funds' ability to change underlying funds from time to time? Would the proposed limitation contribute to changes in how acquiring funds allocate their assets to acquired funds? For example, would acquiring funds be more likely to invest in larger funds, or in ETFs rather than mutual funds, in order to avoid the redemption limit? Would the proposed redemption condition create a competitive disadvantage for smaller acquired funds or acquired funds that are not traded on the secondary market?

- How would the proposed redemption limitation affect an acquiring fund's liquidity risk management?
- Would acquiring funds incur significant costs from a mandatory prohibition on redemption of acquired fund shares once the 3% statutory limit has been exceeded? Should the proposed redemption limitation, like the one in section 12(d)(1)(F) of the Act, be voluntary at the election of an acquired fund? If so, what other safeguards could be added to protect against undue influence?
- If an acquiring fund redeems shares in multiple transactions, should the acquiring fund calculate the total percentage redeemed by adding the percentage total of each redemption or should we provide alternative guidance regarding this calculation? For example, should a fund calculate the percentages as of the time of the latest redemption?
- Should the proposed redemption limit apply to an acquiring fund's advisory group, rather than each acquiring fund individually, in order to address the potential for large-scale redemptions that could originate from a fund group? Alternatively, should the proposed redemption limit apply, on an aggregate basis, to affiliated acquiring funds, or acquiring funds with the same exact portfolio managers, or that have in common at least one portfolio manager, as listed in the registration statement? If so, should the redemption limit be higher (*e.g.,* no more than 5% of the acquired fund's total outstanding shares during any 30-day period)? What are the benefits and drawbacks of such an approach? How would this condition affect fund operations? How would funds design compliance policies and procedures to comply with this condition? Would it be difficult to track this type of redemption limit? If so, why? Would this better protect against undue influence in acquired funds? If so, how?
- Notwithstanding that the proposed condition limits the ability of an acquiring fund to redeem, rather than limiting the ability of an acquired fund to honor redemption requests, should we provide exemptions from section 22(e) of the Act in connection with this condition?
- Does the proposed condition appropriately limit the threat of redemption that an acquiring fund could otherwise use to unduly influence or control an acquired fund? If not, are there other conditions that would better address the risks associated with undue influence or control? For example, do the conditions in our existing orders more effectively limit the ability of an acquiring fund to unduly influence or control an acquired fund? Should we codify those conditions (including the procedural requirements, board findings, and participation agreements) instead of or in addition to including a redemption condition in the rule?
- As discussed above, we believe that participation agreements would not be necessary in light of the proposed conditions of rule 12d1–4. Are there benefits to participation agreements, however, that suggest we should include this requirement? For example, do participation agreements help funds determine who is investing in the funds above the statutory limits? Do participation agreements require the parties to a fund of funds arrangement to provide information necessary for compliance with other provisions of the Act? For example, do participation agreements require acquiring funds and acquired funds to provide lists of affiliates to aid in monitoring compliance with section 17(a)? How would funds use this information in complying with the conditions in proposed rule 12d1–4? Without participation agreements, would an acquired fund have sufficient information about the acquiring funds that hold its shares? Would funds continue to enter into participation agreements even if not required under the rule?
- Should an acquired fund, its principal underwriter, and a broker or a dealer that relies on the rule be prohibited from redeeming (or from submitting an order to redeem) acquiring fund shares that exceed the 3% limit in section 12(d)(1)(A)(i)? Should this prohibition apply only to an acquired fund that is a registered open-end fund, along with its principal underwriter and broker or dealer since section 12(d)(1)(B) applies to only those entities? Would an acquired fund (along with its principal underwriter, and a broker or a dealer that relies on the rule) have difficulty identifying acquiring funds investing in the acquired fund in reliance on rule 12d1–4? If we included this prohibition, should we also include the related safe harbors for an acquired fund, its principal underwriter, and a broker or dealer that we proposed in 2008? [136] Alternatively, should we consider including a knowledge qualifier in the prohibition, similar to the one included in section 12(d)(1)(B) itself? For example, should we prohibit an acquired fund (or its principal underwriter, or a broker or a dealer) only from *knowingly* redeeming shares acquired by the acquiring fund in excess of the 3% limit in section 12(d)(1)(A)(i)?
- Are there alternative approaches to a redemption limitation that we should consider? For example, should we consider requiring acquired funds relying on the rule to set a redemption limit based on their evaluation of the effect of large redemptions on the acquired fund? If so, what parameters should we establish for such an evaluation? Would this approach raise investor protection concerns? For example, should we require the acquired fund to evaluate historical redemptions to determine what limit on redemptions is appropriate? Should we require acquired funds to disclose the redemption limit on Form N–CEN?
- Alternatively, should we consider requiring the acquiring fund to provide advance notice to an acquired fund prior to a large redemption? If so, what threshold should trigger this notice requirement (*e.g.,* 3% or higher), and how far in advance should the acquiring fund provide notice? Similarly, should we require an acquiring fund to provide notice to an acquired fund before investing in the fund in reliance on rule 12d1–4? Should we consider permitting an acquired fund to impose redemption fees on acquiring funds that make redemptions over a certain limit? [137] If so, what should that limit be?

3. Duplicative and Excessive Fees

We are proposing conditions in rule 12d1–4 that are designed to prevent duplicative and excessive fees in fund of funds arrangements, a key concern underlying the enactment of section 12(d)(1).[138] The conditions vary based

[136] *See supra* footnote 134.

[137] Funds are currently permitted to impose redemption fees in certain circumstances. *See* Mutual Fund Redemption Fees, Investment Company Act Release No. 26782 (Mar. 11, 2005) [70 FR 13328 (Mar. 18, 2005)] (adopting rule 22c–2 under the Act).

[138] *See* Investment Trust Study, *supra* footnote 13 at ch. 7, 2725–39, 2760–75, 2778–93. The Investment Trust Study observed that controlling persons profited from duplicative fees at the

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on the structural characteristics of the acquiring fund, but generally hinge on a determination that the arrangement's aggregate fees do not implicate the historical abuses that section 12(d)(1) was intended to prevent. We believe that the proposed condition would help serve to protect acquiring fund investors from duplicative fees.

a. Management Companies

In cases where the acquiring fund is a management company, proposed rule 12d1–4 would require the acquiring fund's adviser to determine that it is in the best interest of the acquiring fund to invest in the acquired fund.[139] The proposed rule would require the adviser to make this determination before investing in acquired funds in reliance on the rule, and thereafter with such frequency as the board of directors of the acquiring fund, by resolution, deems reasonable and appropriate, but in any case, no less frequently than annually. The proposed rule also would require the adviser to report its finding and the basis for the finding to the board.

Investment Adviser Review and Reporting. In finding that it is in the best interest of the acquiring fund to invest in an acquired fund, the proposed rule would require the acquiring fund's investment adviser to evaluate: (i) The complexity of the fund of funds structure; and (ii) the aggregate fees associated with the fund's investment in an acquired fund. We believe it is appropriate to require the acquiring fund's investment adviser to make these evaluations because whether to invest in an acquired fund to achieve a fund's investment objective, rather than other types of assets, is a question of portfolio management. The acquiring fund's board of directors would be required to review these arrangements, and any conflicts they may present, as part of its oversight responsibilities. The proposed evaluations are designed both to help guard against the construction of a complex structure that could be confusing to the acquiring fund's shareholders and to prevent excessive layering of fund costs.[140]

In evaluating the complexity of a fund of funds structure, an adviser should consider the complexity of an 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. The adviser should consider whether an investment in an acquired fund would circumvent the acquiring fund's investment restrictions and limitations. The adviser also should consider whether an acquired fund invests in other funds.[141]

In evaluating the fees associated with the fund's investment in acquired funds, an adviser should consider the fees of all tiers in the fund of funds arrangement with an eye towards duplication. As part of this analysis, 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 services to the acquiring fund. The adviser should consider sales charges and other fees, including fees for recordkeeping, sub-transfer agency services, sub-accounting services, or other administrative services. In particular, the adviser should consider whether these fees could be duplicative or excessive when evaluating an investment in a particular acquired fund. While not required under proposed rule 12d1–4, fee waivers would be one way to mitigate the duplicative fee concerns.[142] Additionally, the adviser should consider reviewing acquired fund share classes to ensure that the acquiring fund is not holding a more expensive share class if a less expensive one is available to the acquiring fund.

The proposed rule does not require an acquiring fund's adviser to make these evaluations in connection with every investment in an acquired fund. For example, in developing policies and procedures reasonably designed to prevent violations of the federal securities laws by the fund, an adviser to a fund that invests regularly in acquired funds as part of its strategy could consider establishing parameters for routine investments in acquired funds, and review individual transactions that are outside of those parameters.[143] Any such policies and procedures should be tailored to the investment objectives and strategies of an individual fund. For example, an adviser to a fund that typically invests in fixed income securities of non-U.S. issuers, but periodically invests in an acquired fund to equitize cash before it can invest a large purchase of fund shares, may decide to make the evaluations in connection with each investment in an acquired fund.

Board Oversight. A management company's board of directors provides an additional layer of protection for an acquiring fund and its investors against the abuses historically associated with fund of funds arrangements. To enable effective board oversight, the proposed rule requires an acquiring fund's adviser to report to the acquiring fund's board of directors its finding that the fund of funds arrangement is in the best interest of the fund and the basis for the finding.[144] The proposed rule requires this reporting before investing in acquired funds in reliance on the rule, and with such frequency as the board of directors of the acquiring fund deems reasonable and appropriate thereafter, but in any case, no less frequently than annually.[145] The frequency of any such review and reporting by the adviser would be determined by resolution of the board, which we believe is in the best position to understand when such a review would be appropriate and the frequency thereof.

The proposed rule would not require the acquiring fund's board to find that advisory fees are based on services

acquiring and acquired fund levels. Additionally, complex multi-tier fund structures made it difficult for shareholders to understand who controlled their fund, to assess the true value of their investments, or to assess the nature of a fund's investment risks.

[139] Proposed rule 12d1–4(b)(3)(i). This condition would apply to open-end funds, ETFs structured as open-end funds, ETMFs, closed-end funds, and BDCs.

[140] In addition, acquiring funds (other than those structured as UITs, discussed below) would be subject to our disclosure requirements for fund investments in other funds, which require all registered funds and BDCs to disclose in their prospectus fee tables expenses paid by both the acquiring and acquired funds so that shareholders can evaluate the costs of investing in a fund that invests in other funds. *See* Instruction 3(f) to Item 3 of Form N–1A; Instruction 10.a to Item 3 of Form N–2. The Commission adopted these disclosure requirements when it adopted rules 12d1–1, 12d1–2 and 12d1–3. *See* Fund of Funds Adopting Release, *supra* footnote 17, at n.67 and accompanying text. We request comment on these disclosure requirements at the end of this section.

[141] *See infra* section II.C.4.

[142] *See, e.g.,* Allianz Funds Multi-Strategy Trust, *et al.,* Investment Company Act Release Nos. 32533 (Mar. 15, 2017) [82 FR 14580 (Mar. 21, 2017)] (notice) and 32598 (Apr. 11, 2017) (order) and related application (providing that the acquiring fund adviser (or sub-adviser) will waive fees otherwise payable to it by an acquiring fund in an amount at least equal to any compensation (including fees received pursuant to any plan adopted by an acquired fund pursuant to rule 12b–1 under the Act) received from certain acquired funds by the adviser or sub-adviser, or an affiliated person of the adviser or sub-adviser, other than any advisory fees paid to the adviser, sub-adviser, or an affiliated person by the acquired fund, in connection with the investment by the acquiring fund in the acquired fund).

Rule 12b–1 under the Act permits a fund to use fund assets to pay broker-dealers and others for providing services that are primarily intended to result in the sale of the fund's shares. Among other things, rule 12b–1 requires that, before using fund assets to pay for distribution expenses, a fund must adopt a written plan describing all material aspects of the proposed financing of distribution. 17 CFR 270.12b–1.

[143] *See* rule 38a–1; *see also* 17 CFR 275.206(4)–7 (rule 206(4)–7 under the Advisers Act).

[144] Proposed rule 12d1–4(b)(3)(i).

[145] Proposed rule 12d1–4(b)(3)(i).

provided that are in addition to, rather than duplicative of, the services provided by an adviser to an acquired fund. Similarly, the proposed rule would not require an acquiring fund's adviser to waive fees in connection with the receipt of compensation from the acquired fund. While these conditions are required by our exemptive orders, we believe they are redundant in light of a fund adviser's and board's fiduciary duties and statutory obligations.[146] As we stated in connection with our omission of a similar condition in rule 12d1–1, 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.[147] 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).[148] Section 36(b) of the Act also imposes on fund advisers a fiduciary duty with respect to their receipt of compensation.[149] 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 to only the services that the acquiring fund's adviser is providing, not taking into account services performed by an adviser to an acquired fund.[150] 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 with respect to this conflict.[151] Accordingly, we do not believe that the elimination of these conditions would lead to an increase in the costs ultimately borne by acquiring fund investors.

The 2008 Proposing Release took a different approach with respect to the fee conditions discussed above. Then, as now, we did not propose to 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.[152] Further, we did not propose to require an acquiring fund's adviser to waive fees in connection with the receipt of compensation from the acquired fund. Instead, our 2008 proposal limited sales charges and service fees charged by the acquiring fund to those set forth in Financial Industry Regulatory Authority's (''FINRA'') rule 2341 (''FINRA sales charge rule'') to prevent duplicative fees.[153] The FINRA sales charge rule takes into consideration sales charges and certain servicing fees charged at both levels of a fund of funds arrangement.

We do not believe it is necessary, however, to include a similar condition in proposed rule 12d1–4. Fund of funds arrangements involving open-end funds and certain closed-end funds already are subject to the FINRA sales charge rule.[154] Even in circumstances where the arrangement is not subject to the sales charge rule, we believe the fee conditions in proposed rule 12d1–4 effectively capture concerns regarding duplicative or excessive fees. In particular, proposed rule 12d1–4 would require acquiring funds to consider fees, which could include expenses such as fees for recordkeeping, sub-transfer agency services, sub-accounting services, or other administrative services that are not covered by the sales charge rule, when finding it is in the best interest of the acquiring fund to invest in the acquired funds.[155]

Recordkeeping Requirements. The proposed rule would require the acquiring fund to maintain and preserve a written record of the adviser's finding, the basis for the finding, and the adviser's reports to the board.[156] These records must be maintained and preserved for at least five years, the first two in an easily accessible place.[157] Funds currently have compliance program-related recordkeeping procedures in place that incorporate this type of retention period, and consistency with that period would minimize any compliance burden to funds related to the preservation of the records.[158] We believe that these recordkeeping requirements would allow for external examinations of advisers' determinations without placing an undue burden on fund advisers or boards of directors.

b. UITs

Proposed rule 12d1–4 sets forth an alternative fee condition when the acquiring fund in a fund of funds arrangement 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 evaluate the complexity of the structure and the aggregate fees associated with the UIT's investment in acquired funds, and find that the fees of the UIT do not duplicate the fees of the acquired funds that the UIT holds or will hold at the date of deposit.[159]

The proposed condition for acquiring UITs under rule 12d1–4 differs from the condition applicable to acquiring management companies for several reasons. First, by statute, a UIT is unmanaged and its portfolio fixed.[160]

[146] Our exemptive orders require the acquiring fund's adviser to waive fees otherwise payable to it by an acquiring fund in an amount at least equal to any compensation (including fees received pursuant to any plan adopted by an unaffiliated fund pursuant to rule 12b–1 under the Act) received from an unaffiliated fund by the adviser, or an affiliated person of the adviser, other than advisory fees paid to the adviser or its affiliated person by an unaffiliated fund, in connection with the investment by the acquiring fund in the unaffiliated fund. *See also supra* footnote 117 (defining ''unaffiliated fund'' for these purposes).

[147] *See* Fund of Funds Adopting Release, *supra* footnote 17, at n.52 and accompanying text.

[148] 15 U.S.C. 80a–15(c); *see also* Fund of Funds Adopting Release, *supra* footnote 17, at n.52 and accompanying text.

[149] 15 U.S.C. 80a–36(b).

[150] *See* Fund of Funds Adopting Release, *supra* footnote 17, at n.52.

[151] *See* Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Request for Comment on Enhancing Investment Adviser Regulation, Investment Advisers Act Release No. 4889 (Apr. 18, 2018) [83 FR 21203 (May 9, 2018)].

[152] *See* 2008 Proposing Release, *supra* footnote 13, at n.234 (''As we noted in the proposing and adopting releases for rule 12d1–1 explaining our exclusion of a similar condition from rule 12d1–1, an acquiring fund board is already obligated to protect the fund from being overcharged for services provided to the fund regardless of any special findings we might require.''). The 2008 proposal would have limited fees using an approach based on the FINRA sales charge rule.

[153] *See id. See also* FINRA rule 2341. The proposal also included specific fee conditions for insurance product separate accounts, which are discussed below.

[154] 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).

[155] *See* proposed rule 12d1–4(b)(3)(i) (requirement to evaluate aggregate fees of the arrangement). *See also* FINRA Notice to Members 92–41: SEC Approval of Amendments to Article III, Section 26 of the NASD Rules of Fair Practice Regarding Limitations on Mutual Fund Asset-Based Sales Charges (Aug. 1992) (definitions of ''sales charges'' and ''service fees'' under FINRA Rule 2341 do not include fees for recordkeeping, transfer agency services, accounting services, or other administrative services), *available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1684.*

[156] Proposed rule 12d1–4(c)(1).

[157] *See id.*

[158] The retention period is consistent with the period provided in rules 22e–4 and 38a–1(d) under the Act.

[159] Proposed rule 12d1–4(b)(3)(ii).

[160] *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

Continued

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. Accordingly, we do not propose to apply the best interest determination requirement to UITs. Second, acquiring UITs typically raise different fee 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.[161]

Due to the unmanaged nature of UITs and the fixed nature of their portfolios, we believe it would be inconsistent with their structure and portfolios to require UITs to re-evaluate their acquired fund finding over time. The requirement only applies, therefore, at the time of the UIT's creation. Nevertheless, this determination generally should consider taking into account 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 requiring a UIT's principal underwriter or depositor to evaluate the complexity of the structure and aggregate fees associated with the UIT's investment in acquired funds, and to make a finding that the UIT's fees do not duplicate the fees 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.[162]

In making this evaluation, the depositor could decide to waive fees payable to it by the UIT on account of any compensation (including any distribution fees) received by the UIT's depositor or any affiliated person from the acquired fund. Our exemptive orders have required UIT depositors to deposit only acquired funds that do not assess a sales load or that waive any sales loads.[163] We believe that fee waivers would be one way to mitigate the duplicative fee concerns, and would allow UIT depositors and affiliates to rely on processes that they may already have in place as a result of the exemptive order conditions.

The proposed condition would apply only at the time of initial deposit for UITs that are formed after the proposed rule's effective date.[164] We do not believe it is necessary to exclude UITs that are already in existence from relying on proposed rule 12d1–4 as acquiring funds. UITs that serve as separate account vehicles funding variable annuity and variable life insurance contracts would be subject to additional fee conditions, as discussed below.[165] The majority of UITs fall into this category.[166] In addition, we believe that existing UIT ETFs are unlikely to rely on proposed rule 12d1–4 as acquiring funds because they replicate the components of broad-based securities indexes that do not currently include funds.[167] 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.[168] 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 of 12–18 months.[169] Given this short term, the number of UITs that have not made the finding required by proposed rule 12d1–4 would quickly decrease over time.

Recordkeeping Requirements. The proposed rule would require an acquiring fund that is a UIT to maintain and preserve a written record of its principal underwriter's or depositor's finding under proposed rule 12d1–4(b)(3)(ii) and the basis for the finding.[170] UITs currently have compliance program-related recordkeeping procedures in place that incorporate this type of retention period, and consistency with that period would minimize any compliance burden to funds related to the preservation of the records.[171] Although the proposed retention period would differ from the period required for certain UIT findings under rule 22e–4 and the general recordkeeping requirements in rule 31a–2, we believe it is appropriate have consistent recordkeeping requirements under rule 12d1–4.[172] We also believe that these recordkeeping requirements would allow for external examinations of the principal underwriter's or depositor's determinations without placing an undue burden on those entities.

c. Separate Accounts Funding Variable Insurance Contracts

With respect to a separate account funding variable insurance contracts that invests in an acquiring fund, the proposed rule would require an acquiring fund to obtain a certification from the insurance company issuing the separate account that it has determined that the fees 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.[173] The standard set forth in section 26(f)(2)(A) of the Act provides that the fees must be

redeemable securities, each of which represents an undivided interest in a unit of specified securities).

[161] 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* 2018 ETF Proposing Release, *supra* footnote 34, at n.52 and accompanying text.

[162] *See supra* section II.C.3.a. (discussing examples of factors that could be considered as part of such an evaluation).

[163] *See, e.g.,* Elkhorn Securities, LLC, *et al.,* Investment Company Act Release Nos. 31022 (Apr. 17, 2014) [79 FR 22720 (Apr. 17, 2014)] (notice) and 31043 (May 13, 2014) (order) and related application. UITs also have agreed as a condition to their exemptive orders to voluntarily comply with the FINRA sales charge rule, even though that rule does not apply to UITs. *See, e.g.,* Ausdal UIT, *et al.,* Investment Company Act Release Nos. 32922 (Dec. 14, 2017) [82 FR 60426 (Dec. 20, 2017)] (notice) and 32953 (Dec. 26, 2017) (order) and related application. As discussed above, we believe the conditions in proposed rule 12d1–4 more effectively capture concerns regarding complex structures and duplicative or excessive fees.

[164] *See* proposed rule 12d1–4(b)(3)(ii).

[165] *See* proposed rule 12d1–4(b)(3)(iii).

[166] According to UIT annual Form N–SAR filings, as of December 2017, insurance UITs made up 673 of the total 719 registered UITs.

[167] There are eight existing UIT ETFs that had total assets of approximately $374 billion as of December 31, 2017, representing 80% 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.

[168] 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 34, at nn. 46–47 and accompanying text.

[169] This estimate is based on staff sampling of equity UIT prospectuses.

[170] Proposed rule 12d1–4(c)(2). These records must be maintained and preserved for at least five years, the first two in an easily accessible place. *Id.*

[171] The retention period is consistent with the period provided in rule 38a–1(d) under the Act.

[172] *See* rule 22e–4(c) (requiring a UIT to maintain 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 for the life of the trust and for five years thereafter). *See also* Liquidity Release, *supra* footnote 128.

[173] Proposed rule 12d1–4(b)(3)(iii).

reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurance company.

The proposed requirement relating to separate account fees is based on the limits in our fund of funds exemptive relief. Our exemptive orders are subject to conditions providing that each acquiring fund will 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. Specifically, 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. Because the proposed rule would not require participation agreements, however, proposed rule 12d1–4 requires that the acquiring fund obtain a certification from the insurance company issuing a separate account that the required reasonableness determination was made.

Our 2008 Proposing Release also included reasonableness determinations for separate accounts, which commenters generally supported.[174] As discussed above, we believe it is appropriate to require an acquiring fund to obtain a certification from each insurance company that issues separate accounts that a reasonableness determination was made in order to better protect investors from duplicative or excessive fees.

Recordkeeping Requirements. The proposed rule would require an acquiring fund to maintain and preserve a written record of each certification obtained by the acquiring fund under proposed rule 12d1–4(b)(3)(iii).[175] As noted above for the other proposed recordkeeping requirements under proposed rule 12d1–4, we believe that consistency with the retention period that funds have in place for other requirements under the Act and our rules would minimize any compliance burden to funds related to the preservation of the records. We also believe that these recordkeeping requirements would allow for external examinations of compliance with this condition without placing an undue burden on the acquiring funds.

We request comment on the proposed fee conditions.

- Would the proposed fee conditions sufficiently reduce the risk of acquiring fund shareholders paying excessive or duplicative fees? Should those conditions vary for management companies, UITs, and insurance product separate accounts as proposed? Alternatively, should all acquiring funds be subject to the same fee condition and if so which condition? Should closed-end funds and BDCs be subject to any special fee conditions with respect to the adviser's determination, or generally?
- Are there other conditions we should consider? For example, should the rule include a condition requiring the waiver of certain fees similar to the one included in our orders? Should the rule include a condition requiring an acquiring fund board to find that the advisory fees charged under an advisory contract are based on services provided that will be in addition to, rather than duplicative of, the services provided by an adviser to an acquired fund?
- Should we require, as proposed, an acquiring fund's investment adviser to determine that it is in the best interest of the acquiring fund to invest in an acquired fund? Should we prescribe the frequency of these determinations? Should we provide additional guidance or requirements in the rule regarding the considerations that an investment adviser should or must take into account when making this determination? Should we require that advisers develop policies and procedures related to fund of funds arrangements before relying on the rule? What parameters, if any, should we place on board oversight of an investment adviser's determinations under rule 12d1–4?
- Alternatively or in addition to the proposed requirements in rule 12d1–4(b)(3)(i), should we require an acquiring fund's investment adviser to make a determination regarding the reasonableness of fees that more closely tracks the determination we propose to require for insurance product separate accounts?
- Are we correct in our belief that the elimination of the fee waiver conditions in our exemptive orders would not lead to an increase in the costs ultimately borne by acquiring fund investors? If not, why not?
- Are the proposed conditions associated with separate accounts appropriate to address concerns regarding layering fees in the three-tier structure typically utilized by insurance product separate accounts? Should we include the reasonableness determinations for separate accounts? Alternatively, should we cap the asset-based sales charges and services fees that may be charged on an aggregate basis by both the acquiring fund and the acquired fund in these arrangements?
- Should we condition proposed rule 12d1–4 on compliance with the FINRA sales charge rule? Should we subject all acquiring funds to the limits in the FINRA sales charge rule, even if that rule does not currently apply to them?
- Should we require, as proposed, that an acquiring fund maintain and preserve written records regarding the finding made under rule 12d1–4(b)(3) for a period of not less than five years (the first two years in an easily accessible place)? Should we require any additional records to be maintained or preserved? Should the records be required to be maintained and preserved for a longer or shorter period of time? For example, should we require UITs to maintain and preserve written records regarding the depositor's finding under proposed rule 12d1–4(b)(3)(ii) for the life of the UIT and for five years thereafter, consistent with other rules under the Act?
- Should we set forth new expense disclosure requirements for acquiring funds structured as UITs? Should such requirements track the disclosure requirements in place for other types of acquiring funds? Are there additional disclosure requirements we should consider?
- 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'' (''AFFE'').[176] The AFFE disclosure was designed to provide investors with: (i) A better understanding of the actual costs of investing in a fund that invests in shares of another fund; and (ii) relevant

[174] *See* 2008 Proposing Release, *supra* footnote 13. *See, also,* BGFA Letter; IDC Letter; ICI Letter (supporting the proposed reasonableness determination, but suggesting that additional fee limits for separate accounts were unnecessary). Commenters supported our proposed exclusion of the two conditions from the exemptive orders that address the layering of fees. *See* ICI Letter; IDC Letter; MFDF Letter.

[175] Proposed rule 12d1–4(c)(3). These records must be maintained and preserved for at least five years, the first two in an easily accessible place. *Id.*

[176] *See* Instruction 3(f)(i) to Item 3 of Form N–1A. Form N–2 has a similar disclosure relating to AFFE. *See* 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%.

information to compare directly the costs of investing in alternative funds of funds or of investing in a fund that invests in one or more other funds to a fund that does not.[177] Since we adopted the AFFE disclosure requirement, however, concerns have been expressed with respect to disclosure of fees and expenses of certain acquired funds, *e.g.,* private funds other than hedge funds, and BDCs.[178] Has the AFFE disclosure requirement been effective? Why or why not?

• Do investors understand the AFFE disclosure? Has the AFFE disclosure requirement helped investors understand the fees and expenses associated with their investment in an acquiring fund? If so, how? For example, has the AFFE disclosure helped in fund selection or fund comparison? Are there ways that we could improve the AFFE disclosure consistent with our intent in adopting the AFFE disclosure requirement? Can we make the disclosure easier to understand or more comparable across pooled vehicles of the same or different types? Are there additional disclosures (*e.g.,* as words, graphics, or pictures) that we should require to clarify how AFFE is calculated in order to help investors to understand the fees and expenses associated with such an investment?

• 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 we exempt certain types of acquired funds from the definition of acquired fund for purposes of AFFE disclosure? If so, which types of acquired funds should be exempted and why? 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?

• 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? Some have commented, for example, that expenses of certain funds are operationally distinct and thus do not raise expense duplication concerns.[179] 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? Are there concerns, other than expense duplication, that warrant disclosure of acquired fund fees and expenses? Should we instead require two disclosures: One without such fees and expenses and one with such fees and expenses?

• Alternatively, should the AFFE disclosure be aligned with the restrictions imposed by Congress on the acquisition limitations imposed by section 12(d)(1)(A)? For example, should we require AFFE disclosures only for acquiring funds that invest in acquired funds in excess of the limits of section 12(d)(1)(A)? Would such an alternative disclosure allow investors to fully understand the acquiring fund's fees and expenses?

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

• Are there ways that we can improve the calculation of AFFE? If so, how should we modify the calculation and why? 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 we revise the AFFE calculation to reflect the number of days the acquiring fund has been in operation, which we believe would be more accurate?

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

4. Complex Structures

As discussed above, one Congressional concern underlying section 12(d)(1) was that complex multi-tier fund structures may lead to excessive fees and investor confusion. As a result, our exemptive orders have included conditions designed to address complex structure concerns, and proposed rule 12d1–4 also would include conditions designed to prevent the creation of complex structures that could cause investor confusion or result in duplicative and excessive fees. We believe that the proposed complex structure conditions would protect acquiring fund investors from unduly complex structures.

Proposed rule 12d1–4's complex structure conditions generally are more comprehensive than the conditions in our orders to address certain multi-tier arrangements that have emerged.[180] Our fund of funds exemptive orders prohibit an acquired fund (*i.e.,* the lower tier in a traditional fund of funds structure) 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 (*i.e.,* the top tier in a traditional fund of funds structure) beyond the limits in section 12(d)(1). Proposed rule 12d1–4 contains conditions designed to restrict fund of funds arrangements to two tiers (other than in limited circumstances).

a. Limitations on Other Funds' Acquisitions of Acquiring Funds

Proposed rule 12d1–4 would include 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 proposed rule would prohibit a fund that is relying on section 12(d)(1)(G) of the Act (15 U.S.C. 80a–12(d)(1)(G)) or the proposed rule from acquiring, in excess of the limits in section 12(d)(1)(A), the outstanding voting 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.[181] This proposed provision would limit the ability of funds relying on section 12(d)(1)(G) or rule 12d1–4 to acquire the securities of acquiring funds, and, as a result, would significantly limit funds' ability to create multi-tier arrangements.

This condition, however, would not prevent another fund from investing all of its assets in an acquiring fund in reliance on section 12(d)(1)(E). We do not believe three-tier structures involving a master-feeder arrangement

[177] *See* Funds of Funds Adopting Release, *supra* footnote 17, at text accompanying n.67 and nn. 53, 88.

[178] *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'').

[179] *See* Fidelity Petition, *supra* footnote 178. As in this release, we previously noted Congressional concerns regarding potentially duplicative fees at the acquiring and acquired fund levels. *See supra* Funds of Funds Adopting Release, *supra* footnote 17, at nn.51–53 and accompanying text; Fund of Funds Proposing Release, *supra* footnote 16, at n.4 and accompanying text and n.68.

[180] As discussed in more detail below, we have observed target date funds that invest, in reliance on section 12(d)(1)(G) of the Act, in acquired funds that then invest in ETFs in reliance on an exemptive order. *See infra* section V.

[181] *See* proposed rule 12d1–4(b)(4)(ii). *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).

present the risk that section 12(d)(1) was designed to address. 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.

This condition also would not prevent other funds from acquiring the voting securities of an acquiring fund in amounts under 3%, effectively creating a type of three-tier structure.[182] We would not, however, expect multiple funds holding less than 3% of the acquiring fund to implicate the historical abuses, such as undue influence, that section 12(d)(1) is intended to prevent.

The proposed rule would require a fund that relies on rule 12d1–4 (or wants to preserve investment flexibility to rely on the rule) to disclose in its registration statement that it is (or may be) an acquiring fund for purposes of rule 12d1–4.[183] The proposed disclosure requirement is designed primarily 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. This disclosure would allow a fund to limit its acquisition of the acquiring fund's securities accordingly.[184] Funds investing in reliance on section 12(d)(1)(G) likely would have less need for this disclosure. In such arrangements, we believe that the acquiring fund 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.

Proposed rule 12d1–4 differs from the complex structures provision we proposed in 2008, which would have required an acquired fund to have a ''disclosed policy'' limiting three-tier arrangements.[185] Instead, the proposed rule would both require certain disclosure and prohibit the acquisition of an acquiring fund's outstanding voting securities by other funds. We believe that these conditions would help prevent the construction of a complex multi-tier structure more effectively than the current participation agreement requirements in our exemptive orders.[186] Thus, the proposed rule would eliminate the need for acquiring funds to negotiate participation agreements with each acquired fund to ensure that the acquired fund's investments would not violate the conditions of the acquiring fund's order.

We considered other conditions that would limit fund investments in acquiring funds. For example, we considered proposing a condition that would prevent an acquiring fund, and any principal underwriter, from knowingly selling the acquiring fund's securities to another fund in excess of the limits in section 12(d)(1)(B) of the Act, except in limited circumstances. We were concerned, however, that some acquiring funds may have limited ability to know the identity of their investors in order to comply with this condition.[187] We also were concerned that this condition could affect funds that are traded on secondary markets differently than other funds, causing certain inadvertent effects on competition.[188]

b. Limitations on Acquired Funds' Acquisition of Other Funds and Private Funds

Proposed rule 12d1–4 would include a condition designed to limit fund of funds arrangements where the acquired fund is itself an acquiring fund. The proposed rule generally would 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).[189] However, the proposed condition would allow arrangements where the acquired fund invests in other funds in certain enumerated circumstances.[190]

Our exemptive orders directly prohibit acquired funds from acquiring securities of any other investment company or private fund, with certain limited exceptions.[191] Proposed rule 12d1–4 would limit the acquired fund's ability to invest in certain other funds consistent with those orders. For example, the proposed condition would prohibit an arrangement where an acquired fund invests beyond the statutory limits in both investment companies and private funds.[192] We believe that the limitation on investments in private funds is an appropriate means to protect against the creation of overly complex structures. The proposed condition also would allow three-tier structures in circumstances that we believe do not raise the same concerns for complex structures as other fund of funds transactions.[193]

Our exemptive orders generally have included the same exceptions.[194] Specifically, proposed rule 12d1–4 would permit arrangements where an acquired fund invests in another fund

[182] 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).

[183] *See* proposed rule 12d1–4(b)(4)(i).

[184] As discussed above, proposed rule 12d1–4(b)(3) also would require an acquiring fund's investment adviser or principal underwriter or depositor to evaluate the complexity of the fund of funds structure.

[185] Our 2008 proposal would have required an acquired fund 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. *See* 2008 Proposing Release, *supra* footnote 13, at n.225 and accompanying text. Some commenters supported this approach. *See* Comment Letter of Katten Muchin Rosenman LLP (May 30, 2008) (''Katten Letter'') (stating that the proposed condition was consistent with the Commission's long-held position that a three-tiered fund arrangement increases structural complexity as well as the likelihood of possible abuses section 12(d)(1) was designed to prevent); NY Bar Letter. On the other hand, one commenter opposed prohibiting three-tiered structures, arguing that they can provide more efficient and cost-effective exposure to certain market segments. *See* ICI Letter.

[186] *See supra* footnote 120 and accompanying text.

[187] A fund may not have information regarding beneficial owners whose shares are held in omnibus accounts registered in the name of intermediaries for the benefit of such investors.

[188] For example, including a knowledge qualifier in this condition could result in secondary market transactions in ETF shares that are outside the condition's scope. Eliminating the knowledge qualifier, however, could make this condition unworkable in connection with omnibus accounts.

[189] *See* proposed rule 12d1–4(b)(4)(iii) (providing that an acquiring fund must not acquire the securities of an acquired fund that invests in excess of the limits in section 12(d)(1)(A) of the Act (15 U.S.C. 80a–12(d)(1)(A)) in other funds or private funds, unless the acquired fund's investment falls within certain covered exceptions).

[190] *See* proposed rule 12d1–4(b)(4)(iii)(A)–(E).

[191] *See, e.g.,* Highland Capital Management, L.P., *et al.,* Investment Company Act Release Nos. 29890 (Dec. 19, 2011) [76 FR 80424 (Dec. 23, 2011)] (notice) and 29918 (Jan. 17, 2012) (order) and related application (''Highland Capital''). Brinker Capital Destinations Trust, *et al.,* Investment Company Act Release Nos. 32478 (Feb. 14, 2017) [82 FR 11277 (Feb. 21, 2017)] (notice) and 32534 (Mar. 16, 2017) (order) and related application (''Brinker Capital'').

[192] *See* proposed rule 12d1–4(b)(4)(iii).

[193] *See* proposed rule 12d1–4(b)(4)(iii)(A)–(E).

[194] The enumerated circumstances have differed depending on the terms of the order. For example, some orders provide that an acquired fund will not invest in funds in excess of the limits in section 12(d)(1)(A)(i)–(iii), except to the extent permitted by Commission exemptive relief to purchase shares of other investment companies for short-term cash management purposes. *See, e.g.,* Highland Capital, *supra* footnote 191. Other orders provide that an acquired fund will not invest in funds in excess of the limits in section 12(d)(1)(A) except to the extent the acquired fund: (i) Acquires securities of another investment company in compliance with section 12(d)(1)(E) and either is an affiliated fund or is in the same group of investment companies as the corresponding master fund; (ii) receives securities as a dividend or as a result of a plan of reorganization of a company; (iii) acquires securities of another investment company pursuant to exemptive relief from the Commission to: (a) Purchase shares of one or more investment companies for short-term cash management purposes, or (b) engage in interfund borrowing and lending transactions; or (iv) invests in a wholly-owned subsidiary of the underlying fund subject to certain conditions. *See, e.g.,* Brinker Capital, *supra* footnote 191.

beyond the statutory limits for short-term cash management purposes or in connection with interfund lending or borrowing transactions.[195] The proposed rule also would permit arrangements where an acquired fund invests all of its assets in a master fund or invests in a wholly-owned subsidiary.[196] Finally, the exceptions would permit arrangements where an acquired fund receives fund shares as a dividend or as a result of a plan of reorganization.[197]

These exceptions are limited in scope and 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. 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 raise concerns regarding undue influence or layering of fees. 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.[198] Similarly, permitting an acquired fund to invest in a wholly-owned subsidiary would allow the acquired fund to gain exposure to certain asset classes.[199] Because the wholly-owned subsidiary's financial statements are consolidated with the financial statement of the acquired fund, we do not believe that this arrangement would be so complex that investors could not understand the nature of these exposures.[200] In addition, interfund transactions are subject to (and would continue to be subject to) conditions specifically designed to address the concerns that they present under the terms of their interfund lending orders.[201] Although we acknowledge that three-tier structures may, in certain circumstances, provide efficient and cost-effective exposure to certain market segments, we continue to believe that three-tier structures can obfuscate the fund's investments, fees, and related risks.[202] We thus believe it is appropriate to prohibit three-tier structures, except in these limited circumstances.

We request comment on the proposed limits on complex structures.

- Are the proposed conditions on complex structures sufficient to prevent investor confusion and other abuses that may be present in a complex structure? If not, what limits should the rule include?
- Should we prohibit other funds from acquiring the securities of an acquiring fund in reliance on section 12(d)(1)(G) or rule 12d1–4 as proposed? Are there other alternatives we should consider?
- Should we prohibit an acquired fund from investing in other investment companies or private funds as proposed?
- As proposed, should we permit arrangements where an acquired fund invests in other investment companies and private funds in certain enumerated circumstances? Alternatively, should we strictly prohibit arrangements where an acquired fund invests in other funds in excess of the limits in section 12(d)(1)(A)? Should we eliminate any of those circumstances? If so, which ones? Should we provide additional guidance regarding these types of investments? Are the limitations appropriately calibrated to mitigate complex structure concerns, including concerns related to transparency and potential investor confusion? Should we adopt different limits? For example, should we only impose a 10% limit on an acquiring fund's investment in other funds?
- Should the complex structures conditions include limits on investments in private funds, given that section 12(d)(1) does not limit a registered fund's investments in private funds? Should the rule instead limit investments in funds only, consistent with the statutory cap on investment in all funds under section 12(d)(1)(A)? Should the overall limit be 10% or should that limit be higher or lower? Why?
- As proposed, should the complex structures condition allow an exception for acquired funds' investment in subsidiaries that are wholly-owned and controlled by the acquired fund? Should we include additional conditions on acquired funds' investments in wholly-owned subsidiaries? For example, should we limit the expenses of such subsidiaries? Should we limit acquired funds' use of such subsidiaries? If so, what limitations should we establish and why?
- Should we include a disclosure requirement in the complex structures condition as proposed? Should the disclosure be in an acquiring fund's registration statement? Are there other more appropriate places that the fund should make such a disclosure? Should we require particular placement of this disclosure, and if so, where? Would the proposed disclosure help ensure that funds are not circumventing the limitations on multi-tier structures in proposed rule 12d1–4? Should we require additional disclosures when a fund of funds structure involves more than two tiers? For example, should an acquiring fund be required to disclose certain fees and expenses associated with a third-tier fund?
- Should we condition proposed rule 12d1–4 on providing additional disclosure about an acquiring fund's investment in an acquired fund more generally? Should we require the additional disclosure only if an acquiring fund's investment in an acquired fund is above a certain threshold? If so, what threshold and why? What types of disclosures should we require to ensure consistency of disclosure across fund of funds structures? For example, how much detail should an acquiring fund give regarding its investment in an acquired fund? Would such disclosures assist investors to better understand the fund's structure?
- To avoid three-tier structures including private funds as a third tier, should the proposed rule prohibit an acquiring fund from relying on the rule to invest in a fund that invests in private funds in excess of the limits in section 12(d)(1)? Would a fund's current disclosure of its investments in private funds be sufficient to put other funds on notice that they should not rely on the rule to invest in such a fund? Should we instead include a specific disclosure

[195] Proposed rule 12d1–4(b)(4)(iii)(B) and (E).

[196] Proposed rule 12d1–4(b)(4)(iii)(A) and (C).

[197] Proposed rule 12d1–4(b)(4)(iii)(D). *See also* 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).

[198] Master-feeder arrangements typically rely on section 12(d)(1)(E) of the Act to operate. *See supra* footnote 19 and accompanying text. The acquired feeder fund in this example would be a pass-through entity.

[199] For example, wholly-owned subsidiaries are typically organized under the laws of the Cayman Islands as an exempted company or under the laws of another non-U.S. jurisdiction in order to invest in commodity-related instruments and certain other instruments for tax and other reasons. *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.

[200] In this type of arrangement, the acquired fund controls the wholly-owned subsidiary and the investment adviser to the acquired fund is also the investment adviser to the wholly-owned subsidiary. 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 id.*

[201] *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 22117 (June 5, 2018) (order) and related application (permitting funds to participate in an interfund lending facility).

[202] *See* 2008 Proposing Release, *supra* footnote 13, at n.226 and accompanying and following text.

requirement for the fund investing in private funds? If so, what should the fund be required to disclose and where should the disclosure be made?

• Should the proposed rule include additional limits on an acquiring fund's ability to serve as an investment for other funds?

• Should there be an exception that allows acquired funds to equitize cash by investing in other funds (*e.g.,* short-term investments in ETFs) beyond the statutory limits or other exceptions? Should the proposed rule permit other types of multi-tier arrangements?

• Should we include an exception for offers of exchange approved under section 11 of the Act?

• Should we prohibit an acquiring fund, and any principal underwriter thereof, from selling or otherwise disposing of any security issued by the acquiring fund to any investment company or any company or companies controlled by such other investment company in excess of the limits in section 12(d)(1)(B) of the Act? Would such an approach have a negative effect on competition? How would this condition affect acquiring funds that are not subject to section 12(d)(1)(B) of the Act? Are there other limits that we should consider?

• Should we allow funds relying on section 12(d)(1)(G) to create three-tier master feeder structures? Should the proposed rule permit acquired funds relying on section 12(d)(1)(G) to invest in a third-tier ''central fund'' in order to centralize the portfolio management of floating rate or other instruments? [203] Should the proposed rule include conditions specifically related to such relief? If so, what conditions? For example, should the proposed rule require that the acquired funds' investments in the central fund be subject to the limits in section 12(d)(1)(A)(ii) and (iii)? Should the proposed rule require the acquired fund to waive certain management fees? Which fees and why? Should the proposed rule prohibit the central fund from charging sales loads, redemption fees, or distribution fees? Should the proposed rule subject the central fund to the acquisition limits under section 12(d)(1)(A)? Should the proposed rule require any board findings? If so, what findings and why?

III. Proposed Rescission of Rule 12d1–2 and Proposed Amendments to Rule 12d1–1

We also are proposing to rescind rule 12d1–2 in order 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.[204] 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.[205]

In 2006, the Commission exercised its exemptive authority to adopt rule 12d1–2.[206] 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 permits 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); [207] (ii) invest directly in stocks, bonds, and other securities; [208] and (iii) acquire the securities of money market funds in reliance on rule 12d1–1.[209] 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.[210] 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 limits in section 12(d)(1)(A) or 12(d)(1)(F)).[211]

Our exemptive orders also have permitted funds to invest in funds within the same group of investment companies.[212] Funds relying on these orders could invest in the same group of related investment companies to the same extent as funds relying on section 12(d)(1)(G). 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. 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.[213]

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.[214] The orders generally

[203] In several staff no-action letters, the staff has stated that, based on certain facts and circumstances, 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, purchases or otherwise acquires shares of a central fund. *See, e.g.,* Franklin Templeton Investments, Staff No-Action Letter (pub. avail. April 3, 2015); Thrivent Financial for Lutherans and Thrivent Asset Management LLC, Staff No-Action Letter (pub. avail. Sep. 27, 2016).

[204] *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.

[205] *See* Fund of Funds Proposing Release, *supra* footnote 16.

[206] *See* Fund of Funds Adopting Release, *supra* footnote 17.

[207] *See* rule 12d1–2(a)(1).

[208] *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.'' This relief provides 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.

[209] 17 CFR 270.12d1–2(a)(3).

[210] Fund of Funds Adopting Release, *supra* footnote 17.

[211] *Id.*

[212] *See* Janus Investment Fund, *supra* footnote 94.

[213] 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.

[214] *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

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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).[215] Under this existing framework, substantially similar fund of funds arrangements are subject to different limitations and conditions.[216] 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.

In order to harmonize the overall regulatory structure, we are proposing to rescind existing exemptive orders (as discussed below) and rule 12d1–2. The rescission of rule 12d1–2 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.[217] Accordingly, funds that wish to invest in funds within the same group of investment companies beyond the limits in section 12(d)(1)(A), as well as other securities and the securities of the other funds, could no longer rely on section 12(d)(1)(G) and rule 12d1–2.[218] Instead, acquiring funds would have flexibility to invest in different types of funds and other asset classes under proposed 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 would enhance investor protection by subjecting more funds of funds arrangements to the conditions in rule 12d1–4.

As we noted in the adopting release for rule 12d1–2, a significant consequence of rule 12d1–2 was that a fund investing directly in equities or bonds could invest a portion of its assets in a fund within the same group of investment companies if the acquisition was consistent with the investment policies of the fund.[219] The proposed rescission of rule 12d1–2 would require such an equity or bond fund to comply with the conditions in proposed rule 12d1–4 for any investment in another fund in excess of the limits of section 12(d)(1)(A)(i).[220] For example, as proposed, such a fund's adviser would be required to engage in an evaluation of the complexity of the fund of funds structure and fees relating to its limited investments in funds—all of which would be subject to board oversight.[221] The proposed rule's redemption limits on acquired funds also would apply to such a fund.[222]

We believe these conditions are necessary to protect investors from the abuses that can arise when a fund's investment in other funds exceeds the prescribed limits. We therefore believe that it is important to require that funds that are investing in other funds in excess of the limits in section 12(d)(1)(A)(i) comply with the conditions underlying proposed rule 12d1–4. As a result, however, proposed rule 12d1–4 could require additional compliance costs for what would be a smaller investment (albeit larger than the limits under section 12(d)(1) of the Act).

The holdings limitations in section 12(d)(1)(G) would apply to those funds that do not wish to comply with the conditions in proposed rule 12d1–4 and instead continue to rely on section 12(d)(1)(G).[223] In order to limit the hardship that the rescission of rule 12d1–2 could have on existing fund of funds arrangements, we are proposing a one-year period after the effective date before rule 12d1–2 is rescinded. We believe that one-year is adequate time for funds relying on current rule 12d1–2 time to bring their future operations into conformity with section 12(d)(1)(G) or proposed rule 12d1–4.

In addition, we are proposing an amendment to rule 12d1–1 under the Act to provide funds relying on section 12(d)(1)(G) with continued flexibility to invest in money market funds outside of the same group of investment companies if they rely on section 12(d)(1)(G).[224] We continue to believe that ''cash sweep'' arrangements do not raise the concerns that underlie section 12(d)(1).[225] We also continue to believe that retaining this flexibility will help to ensure that funds in smaller complexes that do not have a money market fund as part of their fund complex may invest available cash in an unaffiliated money market fund, subject to the conditions of rule 12d1–1.[226] This limited flexibility may come with some reduction in costs associated with complying with section 12(d)(1)(G)'s limited conditions.[227]

We request comment on the proposed rescission of rule 12d1–2 and the proposed amendments to rule 12d1–1.

- Should we rescind rule 12d1–2 as proposed? How would the proposed rescission affect funds that currently rely on section 12(d)(1)(G)? Would any funds be required to alter their investment strategies or holdings as a result of the change? Would funds currently relying on rule 12d1–2 have any challenges with relying on the conditions in proposed rule 12d1–4? If so, which conditions and why? For example, what effect would the rescission of rule 12d1–2 have on a fund that invests the majority of its assets in non-fund securities, but invests a portion of its assets in affiliated funds?
- Would funds that are currently relying on rule 12d1–2 rely on proposed rule 12d1–4? Alternatively, would such funds change their holdings in order to rely on section 12(d)(1)(G)? What factors would funds consider in determining which exemption to rely on?
- Should we continue to allow funds relying on section 12(d)(1)(G) to acquire the securities of money market funds that are not in the same group of investment companies in reliance on rule 12d1–1 as proposed? If not, why not? Should we amend rule 12d1–1 as proposed or would it be more appropriate to amend rule 12d1–2 to allow only investment in money market funds?

short-term cash management purposes or to engage in interfund lending).

[215] *See supra* footnote 117 and accompanying text (regarding conditions applicable to unaffiliated acquired funds).

[216] *See also supra* footnote 28.

[217] 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).

[218] 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* footnotes 19 and 20 and accompanying text.

[219] *See* Fund of Funds Adopting Release, *supra* footnote 17, at n.60 and accompanying text.

[220] An equity or bond fund that holds securities could not rely on section 12(d)(1)(G) if rule 12d1–2 is rescinded because section 12(d)(1)(G) is available only to funds that invest in other funds within the same group of investment companies, government securities and short-term paper. *See also supra* footnote 217 (discussing proposed amendment to rule 12d1–1).

[221] *See* proposed rule 12d1–4(b)(3)(ii). *See also supra* section II.C.3.a.

[222] *See* proposed rule 12d1–4(b)(2). *See also* supra section II.C.2.

[223] Section 12(d)(1)(G)(i) (limiting investments to open-end funds and UITs within the same group of investment companies, government securities, and short-term paper).

[224] Proposed rule 12d1–1(a) providing 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.

[225] Funds of Funds Adopting Release, *supra* footnote 17, at n. 23 and accompanying text.

[226] *See id.,* at section II.A.1(a).

[227] *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)).

• Alternatively, should we amend rule 12d1–2 to include conditions? If so, should we consider expanding the types of investments that are permissible under rule 12d1–2 to include investments other than securities, such as real estate, futures contracts, and other financial instruments that may not qualify as securities under the Act? [228]

• We are proposing a one-year period before rescinding rule 12d1–2. Is the one-year period an appropriate amount of time to allow funds of funds relying on current rule 12d1–2 to come into compliance with proposed rule 12d1–4 or section 12(d)(1)(G)? If not, how long should this period last? Why? Alternatively, should we grandfather funds that are relying on section 12(d)(1)(G) and rule 12d1–2 as of the date of this proposal?

IV. Amendments to Form N–CEN

On October 13, 2016, the Commission adopted Form N–CEN, a structured form that requires registered funds to provide census-type information to the Commission on an annual basis.[229] We are proposing amendments to Form N–CEN to conform to our proposed fund of funds arrangement rulemaking. Item C.7. of Form N–CEN requires management companies to report whether they relied on certain rules under the Investment Company Act during the reporting period. For example, Item C.7.a. currently requires management companies to disclose if they are relying on rule 12d1–1. We are proposing to add a requirement to Form N–CEN that would require management companies to report if they relied on rule 12d1–4 or the statutory exception in section 12(d)(1)(G) during the reporting period.[230] While Form N–CEN already requires a management company to report if it is a fund of funds,[231] we are proposing 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, including compliance with the Paperwork Reduction Act.[232]

UITs also are required to file reports on Form N–CEN. However, the UIT specific section of Form N–CEN does not require a UIT to identify if it is a fund of funds. For the same reasons discussed above, we are proposing to require UITs to report if they relied on proposed 12d1–4 or the statutory exception in section 12(d)(1)(G) during the reporting period.[233]

We request comment on our proposed amendments to Form N–CEN.

• Should we require any additional information on Form N–CEN concerning proposed rule 12d1–4 or section 12(d)(1)(G)? Should we require identification of reliance on any other fund of funds exemptive rules? For example, should we require UITs to report on Form N–CEN if they are funds of funds or relied upon rule 12d1–1 during the relevant period? Should we require funds to identify any statutory exception to section 12(d)(1)(A) that the fund relied upon during the relevant period (*e.g.,* section 12(d)(1)(E) or 12(d)(1)(F))? If we do not rescind rule 12d1–2, should we require funds to report that they relied on rule 12d1–2? Should we require funds to report if they relied on rule 12d1–3?

• Should we require BDCs to report similar information to management companies? If so, since BDCs do no file reports on Form N–CEN, in what form should we require such information be reported?

V. Proposed Rescission of Exemptive Orders; 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 proposing to rescind the orders permitting fund of funds arrangements.[234] The orders covered by this rescission include all orders granting relief from sections 12(d)(1)(A), (B), (C), and (G) of the Act with one limited exception. Specifically, we do not propose to rescind the exemptive orders providing relief from section 12(d)(1)(A) and (B) granted to allow certain interfund lending arrangements.[235] 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, they do not result in the pyramiding of funds or the related potential abuses that the proposed rule is designed to address, and thus are not included within the scope of the proposed rule.

We do, however, propose to rescind the exemptive orders providing relief from sections 12(d)(1)(A) and (B) that has been included in our ETF and ETMF orders.[236] We believe 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. For the reasons discussed above, we expect that the operations of most existing fund of funds arrangements would not be significantly negatively affected by the need to comply with the requirements of proposed rule 12d1–4, as opposed to their orders.[237]

However, the rescission of exemptive orders could have an effect on certain funds relying on section 12(d)(1)(G). Although 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), it does not require the acquired fund to have a policy that prohibits it from acquiring the securities of a fund beyond the limits in section 12(d)(1)(A) in reliance on an exemptive order issued by the Commission.[238] We have observed some funds that invest in acquired funds in reliance on section 12(d)(1)(G) of the Act that in turn invest in ETFs in reliance on an exemptive order. If the existing exemptive orders are rescinded, acquired funds could be required to reallocate or reduce underlying acquired fund investments

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[228] The staff has stated that, based on certain facts and circumstances, it would not recommend that the Commission take any enforcement action under section 12(d)(1)(A) (and other sections of the Act) if a fund relying on section 12(d)(1)(G) invests a portion of its assets in investments that may not be securities. *See* Northern Lights Fund Trust, Staff No-Action Letter (pub. avail. Jun. 29, 2015).

[229] *See* Reporting Modernization Adopting Release, *supra* footnote 48.

[230] Proposed Items C.7.k. and C.7.l. of Form N–CEN.

[231] *See* Item C.3.e of Form N–CEN.

[232] 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* proposed 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)'').

[233] Proposed Items F.18 and F.19. of Form N–CEN.

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

[235] *See, e.g.,* Ivy Funds, *et al.,* Investment Company Act Release Nos. 31068 (June 2, 2014) [79 FR 32779 (June 6, 2014)] (notice) and 31138 (June 30, 2014) (order) and related application.

[236] Some of the exemptive orders we have issued to ETFs include relief permitting ETFs to use certain master-feeder arrangements. We have proposed to rescind that master-feeder fund relief, while grandfathering ETF master-feeder arrangements relying on that relief as of June 28, 2018, as part of an ETF proposal. *See* 2018 ETF Proposing Release, *supra* footnote 34. In addition, we understand that existing ETMFs currently rely on the master-feeder relief in the orders and do not propose to rescind that relief here. *See* Eaton Vance, *supra* footnote 27.

[237] *See, e.g.,* section III.

[238] Section 12(d)(1)(G)(i)(IV).

or the acquired funds would be required to reduce their investments in ETFs. As discussed in more detail below, there could be resulting costs. We believe, however, that this condition is appropriate in order to prevent the creation of overly complex structures for affiliated funds of funds and eliminate those that currently exist. In order to limit the hardship that revocation of these orders could have on existing fund of funds arrangements, we are proposing a one-year period after the effective date before rescission to give acquiring and acquired funds relying on these exemptive orders time to conform their operations with the requirements of the proposed rule and rule amendments.

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. The proposed rule would be 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. Recipients of prior orders may make their views known in the context of the comment process that accompanies this rulemaking, and those views will be given due consideration. Finally, funds would be able to request Commission approval to operate as a fund of funds that does not meet the requirements of the proposed rules.

We request comment on our proposal to revoke existing orders:

- Should we rescind existing fund of funds orders? If not, why not? Should we revoke the fund of funds provisions of the ETF orders and the ETMF orders (with the exceptions described above)?
- As discussed above, we are proposing a one-year period after the effective date before rescinding exemptive orders. Is the one-year period an appropriate amount of time to allow funds of funds relying on the orders to bring their funds into compliance with the rules? If not, how long should this period last? Why?
- Are we correct in our belief that existing funds of funds would not face significant challenges in complying with the conditions of proposed rule 12d1–4 rather than their exemptive orders?
- Are we correct in our understanding that certain funds rely on both section 12(d)(1)(G) and ETF exemptive orders in order to create multi-tier fund of funds arrangements? If so, would what challenges would such funds face if the fund of funds portion of the ETF exemptive orders is rescinded?
- Should we consider other approaches? For example, should we consider not rescinding any of the orders? Under this approach, in which our exemptive orders would be left in place, funds that are otherwise structured in similar ways may end up operating under different sets of conditions. Would permitting funds to operate under different sets of conditions have an adverse effect on competition?

In addition, staff in the Division of Investment Management is reviewing staff no-action and interpretative letters relating to section 12(d)(1) to determine whether any such letters should be withdrawn in connection with any adoption of this proposal. If the rule is adopted, some of the letters may be moot, superseded, or otherwise inconsistent with the rule and, therefore, would be withdrawn. To the extent that there are concerns with the withdrawal of any of the letters, commenters should provide comments.

VI. Economic Analysis

A. Introduction

Proposed rule 12d1–4 would 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. In connection with the proposed rule, we are also proposing to rescind rule 12d1–2 under the Act and most of our exemptive orders granting relief from sections 12(d)(1)(A), (B), (C), and (G) of the Act. We are also proposing a related amendment to rule 12d1–1. For purposes of this economic analysis, we use the term ''rule proposal'' to refer collectively to proposed rule 12d1–4, the proposed rescission of rule 12d1–2 and the exemptive orders, and the proposed amendment to rule 12d1–1.

The rule proposal would affect funds' investment flexibility, increase regulatory consistency and efficiency, and eliminate the need for funds to obtain an exemptive order from the Commission and incur the associated costs and delays. At the same time, the rule proposal would impose one-time costs to funds that would need to assess whether their operations are consistent with the rule proposal, particularly to those funds relying on an order being withdrawn in connection with the rulemaking. In addition, the conditions in proposed rule 12d1–4 would impose certain one-time and ongoing costs to funds, such as compliance, monitoring, and recordkeeping costs.[239]

We are sensitive to the economic effects that may result from the rule proposal, including the benefits, costs, and the effects on efficiency, competition, and capital formation. These potential effects, as well as possible alternatives to the rule proposal are discussed in detail below.

B. Economic Baseline

The baseline against which the costs, benefits, and the effects on efficiency, competition, and capital formation of the rule proposal are measured consists of the current state of the market and the current regulatory framework for funds of funds.

1. Current State of the Fund of Funds Market

To establish a baseline for the economic analysis of the rule proposal we provide descriptive statistics on the current state of the fund of funds market as of June 2018. For purposes of this analysis, we define a fund of funds as a fund that invests a non-zero percentage of its assets in other funds.[240] Funds whose only investments in other funds are in money market funds and master-feeder funds (*i.e.,* funds of funds created in reliance on section 12(d)(1)(E)) are excluded from our definition of a fund of funds for the purpose of the baseline.[241] Hence, our definition of funds of funds includes: (i) Funds of funds whose investments are within the limits of sections 12(d)(1)(A) and (B); (ii) funds of funds that were structured in reliance on sections 12(d)(1)(F) or (G); and (iii) funds of funds that were formed in reliance on exemptive relief on which proposed rule 12d1–4 is based. We provide descriptive statistics for these three categories of funds of funds and also for single-tier funds to provide an understanding of the funds market as a whole and because the rule proposal would affect both current and prospective funds of funds.

Table 1 below provides descriptive statistics for acquiring and acquired

[239] We expect that the proposed amendments to Form N–CEN would yield immaterial economic effects. In particular, we expect that the proposed amendments to Form N–CEN would increase the annual estimated burden hours associated with preparing and filing Form N–CEN by approximately 0.1 hours for each fund. In addition, the proposed amendments to Form N–CEN would facilitate the supervision and regulation of the fund industry, which would ultimately benefit fund investors, but any such effects are likely small. Hence, the economic analysis focuses on the economic effects of proposed rule 12d1–4, the proposed rescission of rule 12d1–2 and the exemptive orders, and the proposed amendment to rule 12d1–1.

[240] Our baseline includes acquiring funds that invest a non-zero percentage of their assets in registered funds, BDCs, and unregistered funds, and it includes as acquired funds only registered funds and BDCs.

[241] As of June 2018, there were a total of 95 master funds and 195 feeder funds based on Morningstar Direct and 10–K filings data.

funds as of June 2018.[242] As Table 1 shows, there are 4,342 acquiring funds with total gross assets equal to $5,761 billion. 31% of all open-end funds, 28% of all UITs, 20% of all ETFs, none of the ETMFs, 31% of all closed-end funds, and none of the BDCs are acquiring funds.[243] Further, 89.5% of the acquiring funds are open-end funds, 0.1% are UITs, 9.1% are ETFs, none are ETMFs, 1.4% are closed-end funds, and none are BDCs. Untabulated analysis shows that 63% of all acquiring funds are funds that invest in other funds beyond the limits in section 12(d)(1)(A), and 24% of all acquiring funds appear to be relying on the statutory exemption in section 12(d)(1)(G) to structure a fund of funds arrangement.[244]

As Table 1 shows, there are 2,521 acquired funds with total gross assets equal to $6,603 billion. 23% of all open-end funds, none of the UITs, 93% of all ETFs, none of the ETMFs, all of the closed-end funds, and 35% of all BDCs are acquired funds. In addition, 59% of the acquired funds are open-end funds, none are UITs, 37% are ETFs, none are ETMFs, 4% are closed-end funds, and 1% are BDCs. Untabulated analysis shows that 41% of all acquired funds are funds listed on a national securities exchange (*i.e.,* listed closed-end funds, ETFs, ETMFs, and listed BDCs).

As Table 1 shows, there are 2,033 acquiring funds in multi-tier structures and 783 acquired funds in multi-tier structures as of June 2018.[245] Multi-tier fund structures are funds of funds that comprise more than two tiers. Untabulated analysis shows that there are 129 multi-tier structures for which the investments in both the second and third tier are within the statutory limits of section 12(d)(1)(A).

TABLE 1—DESCRIPTIVE STATISTICS FOR SINGLE-TIER FUNDS, ACQUIRING FUNDS, AND ACQUIRED FUNDS

	N of funds	Gross assets of funds (bn $)	*N* of acquiring funds	Gross assets of acquiring funds (bn $)	*N* of acquired funds	Gross assets of acquired funds (bn $)	*N* of acquiring funds in multi-tier structures	*N* of acquired funds in multi-tier structures
Open-end	7,602	16,783	2,841	5,154	1,085	3,880	1,159	447
UITs	4,706	18	969	5	0	0	767	0
ETFs	1,885	2,622	424	522	923	2,433	83	220
ETMFs	9	0.10	0	0	0	0	0	0
Closed-end	469	258	108	80	469	258	24	116
BDCs	88	94	0	0	44	33	0	0
Total	14,759	19,775	4,342	5,761	2,521	6,603	2,033	783

This table reports descriptive statistics for single-tier funds, acquiring funds, and acquired funds as of June 2018. A fund of funds is a fund that invests a non-zero percentage of its assets in other funds. Funds, whose sole fund investments are in money market funds and master-feeder funds are excluded from the definition of fund of funds. Data is retrieved from Morningstar Direct, Morningstar Investment Company Holdings, and funds' 10–K and 10–Q filings. Total gross assets is the sum of all fund holdings, and we consider both long and short fund positions in the estimation of total gross assets.

Table 2 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 95% and above of their assets in other funds as of June 2018.[246] The table shows that the majority of acquiring funds invest either less than 10% or more than 90% of their assets in other funds. In particular, 31% of the acquiring open-end funds, 3% of the acquiring UITs, 37% of the acquiring ETFs, and 63% of the acquiring closed-end funds invest less than 10% of their assets in other funds. Moreover, 50% of the acquiring open-end funds, 74% of the acquiring UITs, 39% of the acquiring ETFs, and 20% of the acquiring closed-end funds invest more than 90% 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 90% threshold likely rely either on sections 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 2—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%]	(95–100%]
Open-end	23	8	8	5	4	4	24	26
UITs	1	2	4	11	7	2	38	36
ETFs	31	6	7	5	7	4	14	25
Closed-end	57	6	7	5	3	1	1	19

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 assets in other funds as of June 2018. ETMFs and BDCs are excluded from this table because we have not identified any acquiring ETMFs and BDCs. Fund holdings data is retrieved from Morningstar Investment Company Holdings database. Percentages may not sum up to 100 due to rounding error.

[242] As of December 2017, there were 663 separate accounts with $1,774 bn total assets. 99.2%, or 658, of these separate accounts are structured as UITs and the remainder 0.8%, or 5, are structured as open-end funds. All of the UIT separate accounts are master-feeder structures. Data for separate accounts is retrieved from Form N–SAR. Separate accounts are not included in the Tables 1–4 and Figure 1 of the economic analysis because of limited structured data for separate accounts.

[243] All percentages in this and the next paragraph are based on funds' total gross assets. Percentages occasionally do not sum up to 100 due to rounding error.

[244] 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 with the same investment adviser. Our methodology may underestimate the number of 12(d)(1)(G) acquiring funds to the extent that the acquiring fund and acquired fund have advisers that are control affiliates. 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).

[245] The number of acquiring funds in multi-tier structures captures the top-tier fund in three-tier structures and the number of acquired funds in multi-tier structures captures the mid-tier fund in three-tier structures.

[246] 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.

The total net assets of funds of funds have increased over time. According to the 2018 ICI Fact Book, the total net assets of open-end funds of funds increased from $638 to $2,216 billion between December 2007 and December 2017, and the total net assets of ETF funds of funds increased from $97 million to $11,944 million between December 2008 and December 2017.[247]

Table 3 below shows the expense ratio, front-end load, and deferred charges for single-tier funds (excluding acquiring funds) in Panel A and for acquiring funds in Panel B.[248] The expense ratio for acquiring funds includes the acquired funds' expense ratio. The equal-weighted average expense ratio for acquiring funds is statistically significantly higher than the equal-weighted average expense ratio for single-tier funds, with the exception of closed-end funds.[249] The results of the comparison of the equal-weighted average front-end load for acquiring and single-tier funds are mixed—acquiring UITs have statistically significantly lower front-end load than single-tier UITs but acquiring open-end funds do not have significantly different front-end load than single-tier open-end funds. The equal-weighted average deferred charges for acquiring UITs are statistically significantly higher than the equal-weighted average deferred charges for single-tier UITs but acquiring open-end funds do not have significantly different deferred charges than single-tier open-end funds. We do not compare the front-end load and deferred charges for single-tier and acquiring closed-end funds because of the limited sample size for acquiring closed-end funds with front-end load and deferred charges.

TABLE 3—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	0.94	0.52	0.91	0.47	5,191
UITs	0.30	0.25	0.25	0.26	4,090
ETFs	0.53	0.23	0.49	0.33	1,738
ETMFs	0.75	0.78	0.84	0.24	18
Closed-end	1.09	1.04	1.17	1.01	455
BDCs	8.87	8.89	8.49	3.23	76
	Front-end load				
Open-end	1.44	1.75	0.92	1.39	2,479
UITs	1.90	1.21	1.00	1.86	3,113
ETFs					
ETMFs					
Closed-end	2.25	1.56	2.25	1.45	16
BDCs	5.70	6.64	5.75	3.51	32
	Deferred charges				
Open-end	0.07	0.06	0.03	0.13	2,479
UITs	2.01	2.11	2.25	0.65	3,113
ETFs					
ETMFs					
Closed-end[250]	0.10	0.16	0.00	0.16	16
BDCs					
Panel B: Acquiring funds	Expense ratio				
Open-end	1.04	0.63	0.96	0.60	2,841
UITs	1.44	1.41	1.49	0.83	969
ETFs	0.69	0.34	0.58	0.51	424
ETMFs					
Closed-end	1.05	0.96	1.10	1.09	108
BDCs					
	Front-end load				
Open-end	1.38	1.27	0.81	1.42	1,424
UITs	0.46	0.47	0.00	0.50	952
ETFs					
ETMFs					

[247] 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* 2018 ICI Fact Book, *supra* footnote 5, at 218 and 256.

[248] The number of funds in Table 3 can be different than the number of funds in Table 1 due to different data requirements to construct the two tables. We exclude no-load funds for the estimation of descriptive statistics for front-end load and deferred charges. 51% of single-tier funds and 45% of acquiring funds are no-load funds.

[249] 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 in scientific work (*see, e.g.,* David H. Kaye and David A. Freedman, *Reference Guide on Statistics,* in Ref. Man. on Scient. Ev., 2nd ed., Washington, DC, Federal Judicial Center, 2000).

Our comparison of fees and expenses for acquiring and single-tier funds 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.

[250] The closed-end funds with front-end load and deferred charges identified in Table 3 are all interval funds.

TABLE 3—EXPENSE RATIO, FRONT-END LOAD, AND DEFERRED CHARGES FOR SINGLE-TIER AND ACQUIRING FUNDS—Continued

Panel A: Single-tier funds	Expense ratio				
	Equal-weighted mean	Value-weighted mean	Median	Standard deviation	N
Closed-end	4.07	2.91	4.50	1.24	5
BDCs					
	Deferred charges				
Open-end	0.08	0.07	0.02	0.13	1,424
UITs	2.25	2.33	2.25	0.51	952
ETFs					
ETMFs					
Closed-end	0.11	0.19	0.00	0.15	5
BDCs					

This table reports descriptive statistics for the expense ratio, front-end load, and deferred charges in percentage points for single-tier funds (excluding acquiring funds) in Panel A and for acquiring funds in Panel B as of June 2018. 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. All of the analysis is conducted at the fund level using asset-weighted average values for multiple-class portfolios except for UITs. Assets at the share-class level are not available for UITs. We exclude no-load funds for the estimation of descriptive statistics for front-end load and deferred charges. ETFs and ETMFs 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. Data for acquiring ETMFs and BDCs is missing because we have not identified any acquiring ETMFs and BDCs. 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 N–2, N–2/A, and 497. Data is winsorized at the 1% and 99% levels.

Table 2 shows that the majority of acquiring funds either invest less than 10% or more than 90% of their assets in other funds. We compare the expense ratio, front-end load, and deferred charges for funds that invest less than 10% and funds that invest more than 90% of their assets in other funds, and find mixed evidence.[251] In particular, the expense ratio for acquiring open-end funds that invest more than 90% of their assets in other funds is lower than the expense ratio for acquiring open-end funds that invest less than 10% of their assets in other funds. For acquiring UITs and ETFs, the expense ratio is higher for those funds that invest more than 90% of their assets in other funds than those that invest less than 10% of their assets in other funds. There is no difference in the expense ratio of the two types of acquiring closed-end funds. Further, front-end load and deferred charges are, on average, higher for acquiring open-end funds that invest more than 90% of their assets in other funds. We find no difference in the front-end load and deferred charges between the two types of acquiring UITs. We do not compare the front-end load and deferred charges for the two types of acquiring closed-end funds because of limited sample size.

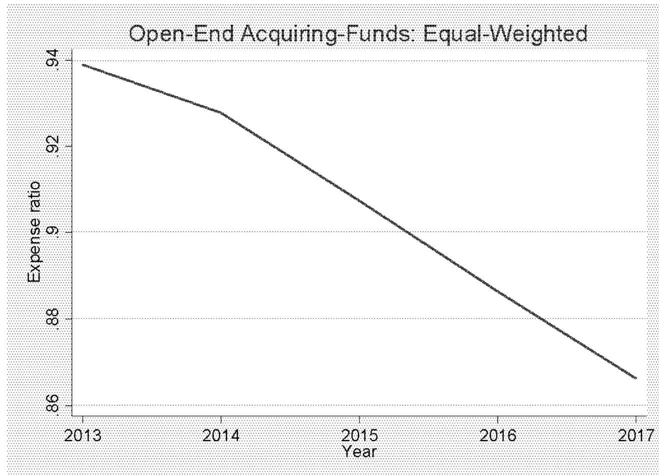
There is some evidence of a decrease in the fund of funds expense ratio over time. According to an ICI report, the equal-weighted (value-weighted) average of the expense ratio of target date open-end funds has decreased from 1.23% (0.67%) in 2008 to 0.85% (0.44%) in 2017.[252] Figure 1 Panels A–C below show a decrease in the equal-weighted average of the expense ratio for open-end funds and ETFs and an increase in the expense ratio for closed-end funds between 2013 and 2017.

[251] *See supra* footnote 249.

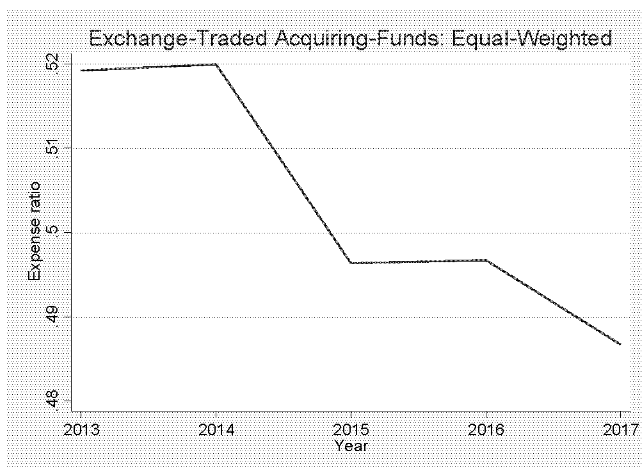
[252] ICI Research Perspective, Trends in the Expenses and Fees of Funds, 2017, April 2018, p. 14.

Figure 1: Equal-weighted average of acquiring funds' expense ratio over time

Panel A: Open-end acquiring funds

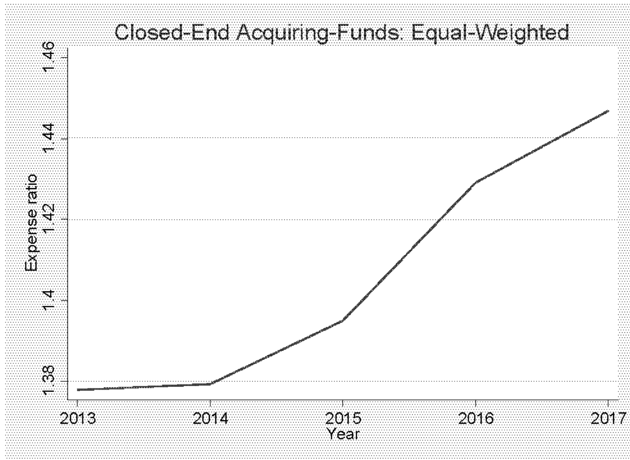


Panel B: Exchange-traded acquiring funds



This figure reports the equal-weighted average of the expense ratio for acquiring funds by fund type between 2013 and 2017. Panel A shows the average expense ratio for open-end funds, Panel B for ETFs, and Panel C for closed-end funds. 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 for acquiring funds is retrieved from the acquiring fund's annual report and it does not include the acquired funds' expense ratio. ETMFs and BDCs are excluded from this figure because we have not identified any acquiring ETMFs and BDCs. There is no historical structured data for the expense ratio of UITs. Data is retrieved from Morningstar Direct and is winsorized at the 1 and 99% levels.

Panel C: Closed-end acquiring funds



This figure reports the equal-weighted average of the expense ratio for acquiring funds by fund type between 2013 and 2017. Panel A shows the average expense ratio for open-end funds, Panel B for ETFs, and Panel C for closed-end funds. 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 for acquiring funds is retrieved from the acquiring fund's annual report and it does not include the acquired funds' expense ratio. ETMFs and BDCs are excluded from this figure because we have not identified any acquiring ETMFs and BDCs. There is no historical structured data for the expense ratio of UITs. Data is retrieved from Morningstar Direct and is winsorized at the 1 and 99% levels.

Table 4 provides descriptive statistics on acquiring funds' investment strategy by fund category as of June 2018. The table shows that the most frequent investment category for acquiring funds is the ''Allocation'' category, which includes target dates funds—42% of the acquiring funds belong to the ''Allocation'' investment category.

TABLE 4—NUMBER OF ACQUIRING FUNDS BY INVESTMENT CATEGORY

	U.S. equity	Sector equity	International equity	Taxable bond	Municipal bond	Allocation	Alternative	Commodities	Total
Open-end	438	97	412	290	23	1,316	248	17	2,841
UITs	90	74	18	146	185	423	33	0	969
ETFs	39	28	192	24	2	41	83	15	424
Closed-end	10	11	7	31	11	25	13	0	108
Total	577	210	629	491	221	1,805	377	32	4,342

This table presents the number of acquiring funds by investment category as of June 2018. ETMFs and BDCs are excluded from this table because we have not identified any acquiring ETMFs and BDCs. ''U.S. Equity'' funds are those that maintain at least 85% exposure to equity and investing at least 70% of assets in US-domiciled securities. ''Sector Equity'' funds are usually equity funds, in that they maintain at least 85% exposure to equity. ''International Equity'' funds include stocks domiciled in diverse countries outside the U.S. though most invest primarily in developed markets. ''Taxable Bond'' funds invest at least 80% of assets in securities that provide bond or cash exposure. ''Municipal Bond'' funds are generally defined by state or national focus and duration exposure. Funds in the ''Allocation'' category seek to provide income and capital appreciation by investing in multiple asset classes. This category is comprised of target date funds, convertibles, world, and tactical allocation funds. ''Alternative'' funds employ a unique investment approach designed to offer returns different from those of the long-only investments in the stock, bond, or commodity markets. ''Commodities'' funds invest in direct holdings or derivative securities that provide exposure to changes in price of commodities.

We request comment on the following:

- Do you agree with our estimate of acquiring funds that rely on section 12(d)(1)(G)? Do you agree with the methodology we use to identify acquiring funds that rely on section 12(d)(1)(G) as described in footnote 244 above? If not, please provide an alternative methodology to identify acquiring funds that rely on section 12(d)(1)(G) to invest in other funds.
- Our analysis identified no acquiring BDCs, no acquiring ETMFs, no acquired UITs, and no acquired ETMFs as of June 2018. Have commenters identified acquiring BDCs, acquiring ETMFs, acquired UITs, or acquired ETMFs? If so, how prevalent are arrangements involving these fund types?

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 relevant no-action and interpretive letters. Section I.B. above describes in detail the current set of statutory provisions governing funds of funds. Below we discuss in more detail the fund of funds exemptive order process and we provide a summary of the existing regulatory framework.

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 acquiring 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. Once a fund adviser/sponsor obtains exemptive relief to structure a fund of funds, the adviser/sponsor may apply this relief to multiple funds of funds. The administrative cost associated with the exemptive order process may be borne both by the fund adviser/sponsor and by the fund. Nevertheless, we lack data 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. In 2017, for non-ETF (ETF) fund of funds exemptive orders, 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 377 (321) days and the average number of application revisions was 3 (2.4).[253] Until the Commission grants exemptive relief, fund advisers/sponsors are not permitted to create certain fund 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 forego certain investments or funds of funds might not be launched in the first place because they have concluded that the costs of seeking an exemptive order would exceed the anticipated benefits of the investment. Nevertheless, the direct and indirect costs of the exemptive order process are partially moderated by the fact that each exemptive order can be used by multiple funds within the same fund complex and the costs of the exemptive order application process are one-time costs.

We request comment on the following:

• Do you agree with our $100,000 administrative cost estimate for a fund to apply for exemptive relief? If not, please provide an estimate of how much it would cost a fund to apply for exemptive relief. Is the cost different for acquiring and acquired funds?[254] Does the cost vary with fund size? How is this cost split between the fund adviser/sponsor and the fund?

b. Exemptive Order Conditions

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.[255]

Undue Influence. To prevent an acquiring fund from exercising undue influence over the acquired fund, existing exemptive orders include the following conditions. First, existing orders mandate that an acquiring fund and its advisory group cannot control an acquired fund unless the acquired fund is part of the same group of investment companies or the acquiring fund's sub-adviser serves as the acquired fund's primary adviser. 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.[256] Second, existing orders include a set of voting provisions that differ depending on the type of acquired fund. Third, existing exemptive orders require acquired fund boards to make certain findings and adopt procedures to prevent overreaching and undue influence by the acquiring fund and its affiliates once the investment in an acquired fund that is not part of the same group of investment companies exceeds the section 12(d)(1) limits. Fourth, exemptive orders require that acquiring and acquired funds enter into participation agreements that state that the funds understand and agree to comply with the terms and conditions of the order. This requirement allows acquired funds to block the acquisition of their shares by acquiring funds that could exercise undue influence over them by refusing to enter into a participation agreement with those funds.

Duplicative and Excessive Fees. Current orders contain conditions designed to prevent duplicative and excessive fees. 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 the 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. For separate accounts funding variable insurance contracts, our exemptive orders require that each acquiring fund should represent in its participation agreement 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.

Complex Structures. Current orders contain conditions designed to limit complex fund structures because complex structures historically have been associated with excessive fees and

[253] ETF fund of funds exemptive order applications are typically submitted together with 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 revisions of the fund of funds exemptive order process. For this reason, statistics for non-ETF and ETF applications for exemptive order are discussed separately.

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. In 2017, for non-ETF (ETF) exemptive order applications, the duration of the exemptive order process varied from 98 (43) to 1,205 (2,318) days from the date of the first filing to the date the order was issued, and the number of the revisions varied from 2 (1) to 6 (6). Data is retrieved from the Investment Company Act Notices and Orders Category Listing, *available at https://www.sec.gov/rules/icreleases.shtml* (accessed on June 11, 2018).

[254] Acquired funds may apply for exemptive relief to be able to sell their shares to acquiring funds beyond the limits of section 12(d)(1)(B) of the Act.

[255] In addition to the exemptive order conditions, fund investors 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.

[256] *See also supra* footnotes 79–82.

investor confusion.[257] Specifically, our current orders prohibit an acquired fund from investing in other funds beyond the limits in section 12(d)(1). The exemptive order conditions contain a number of exceptions to the complex structures prohibition. In particular, acquired funds are permitted to buy shares of lower-tier funds in reliance on section 12(d)(1)(E) of the Act, for short-term cash management purposes, in a subsidiary that is wholly-owned and controlled by the acquired fund, or as part of the receipt of securities as a dividend or as a result of a plan of reorganization of a company.

c. Relevant Statutory Provisions

As an alternative to obtaining an exemptive order, open-end funds and UITs could rely on section 12(d)(1)(G) to invest in other funds that are in the same group of investment companies beyond the limits of section 12(d)(1). Section 12(d)(1)(G) limits funds' investment flexibility by only permitting investments in government securities and short-term paper in addition to unlimited investments in funds that belong in the same group of investment companies. Rule 12d1–2 relaxes the investment restrictions of section 12(d)(1)(G) by providing funds relying on section 12(d)(1)(G) with the ability 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. The Commission also has issued exemptive orders granting funds relief from rule 12d1–2(a) to the extent necessary to permit an acquiring fund that invests in acquired funds in reliance on section 12(d)(1)(G) of the Act to invest in financial instruments that may not be ''securities.''

Funds also can structure fund of funds arrangements in reliance on 12(d)(1)(E), which allows an acquiring fund to invest all of its assets in a single fund so that the acquiring fund is, in effect, a conduit through which investors may access the acquired fund.

Lastly, funds can structure funds of funds in reliance on 12(d)(1)(F), which permits funds to take small positions (up to 3% of another fund's securities) in an unlimited number of other funds. A fund relying on section 12(d)(1)(F) may be restricted in its ability to redeem shares of the acquired fund and is prohibited by the Act from using its voting power to influence the outcome of shareholder votes held by the acquired fund.

d. Relevant No-Action and Interpretive Letters

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 relief provided in 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;[258] (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.

The staff letters also state that, for purposes of rule 12d1–2(a)(1) under the Act, the term ''group of investment companies,'' as defined in section 12(d)(1)(G)(ii) of the Act, does not include closed-end funds. Under this staff position, open-end funds, or UITs may invest in a closed-end fund under rule 12d1–2(a)(1) even if the closed-end fund is part of the same group of investment companies.

C. Benefits and Costs and Effects on Efficiency, Competition, and Capital Formation of Rule Proposal

Where possible, we have sought to quantify the benefits, costs, and effects on efficiency, competition, and capital formation expected to result from the rule proposal. However, we are unable to reliably quantify many of the economic effects in light of the uncertainty about how market participants would react to the changes in regulatory structure under the rule proposal. For example, we are unable to estimate the number of new funds of funds that potentially would be created as a result of the adoption of the rule proposal, 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 potential adoption of the rule proposal. Therefore, much of the discussion below is qualitative in nature, although we try to describe, where possible, the direction of the economic effects.

We request comment on the following. In providing comment on the questions below, please describe your methodology and, where possible, identify sources of data.

• Would the rule proposal result in a change in the number of funds of funds? Please estimate the potential change in the number of funds of funds as a result of the rule proposal.

• Our analysis shows no acquiring BDCs and ETMFs as of June 2018. Would the rule proposal result in an increase in the number of acquiring BDCs and ETMFs? If not, why not?

• Would the rule proposal affect the diversity of available funds of funds? If yes, how and why would the rule proposal affect the diversity of available funds of funds?

• Would the rule proposal affect investor demand for funds of funds? If yes, in which direction and through which mechanisms would the rule proposal affect investor demand for funds of funds? Please estimate the potential change in investor demand for funds of funds as a result of the rule proposal.

• Would existing acquiring funds change their investments as a result of the rule proposal, if adopted? Why and in which ways? Relatedly, would funds that invest in acquiring funds be required to change their investments as a result of the rule proposal? If yes, in which ways?

[257] Concerns about complex structures are partially mitigated by funds' disclosures. For example, funds are required to report their portfolio holdings on a semi-annual basis in the shareholder reports. Acquiring funds are required to report the aggregate expenses of the acquired and acquiring funds in their prospectuses. Further, feeder funds must disclose in their registration statements that they invest in master funds. These disclosure requirements complement the complex structure conditions in the current exemptive orders.

[258] 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.

- What is the net effect of the proposed conditions in rule 12d1–4 and the elimination of certain conditions that are included in our exemptive orders on administrative costs for both acquiring and acquired funds?

1. Benefits and Costs

a. Funds' Investment Flexibility

It is unclear ex-ante how the rule proposal would affect funds' investment flexibility. On one hand, proposed rule 12d1–4 would expand funds' investment flexibility by expanding the scope of permissible acquiring and acquired funds relative to the current exemptive orders. On the other hand, the conditions in proposed rule 12d1–4 and the proposed rescission of rule 12d1–2 and the exemptive orders would restrict certain funds' investment flexibility and would require certain acquiring funds to change their investments in acquired funds compared to the baseline.

Our current exemptive orders permit only certain funds to invest in other funds beyond the limits of section 12(d)(1).[259] Proposed rule 12d1–4 would expand the scope of permissible acquiring and acquired funds by permitting all open-end funds, UITs, ETFs, ETMFs, listed and unlisted closed-end funds, and listed and unlisted BDCs to invest in open-end funds, UITs, ETFs, ETMFs, listed and unlisted closed-end funds, and listed and unlisted BDCs beyond the limits of section 12(d)(1). By expanding the scope of permissible acquiring and acquired funds, proposed rule 12d1–4 would enhance acquiring funds' investment flexibility and would increase acquired funds' access to financing.

At the same time, the rule proposal would limit funds' investment flexibility in order to protect fund investors from undue influence, duplicative and excessive fees, and complex structures. First, proposed rule 12d1–4 would prohibit an acquiring fund that acquires more than 3% of an acquired fund's outstanding shares from redeeming or submitting for redemption or tendering for repurchase more than 3% of the acquired fund's total outstanding shares in any 30-day period. This condition would limit funds' investment flexibility because it would reduce a fund's ability to quickly change its portfolio.[260] Untabulated analysis shows that as of June 2018, out of the 4,342 acquiring funds, 809 hold more than 3% of an acquired fund's outstanding shares and would thus be affected by the proposed limit on fund redemptions.[261] In addition, between January 2017 and June 2018, 0.76% (0.16%) of the redemptions of listed (unlisted) acquired fund shares exceeded the 3% redemption limit.[262] Hence, we expect that the impact of the redemption limit on funds' investment flexibility would likely be small.

Second, proposed rule 12d1–4 and the rescission of the exemptive orders would limit funds' investment flexibility by limiting certain multi-tier structures. 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 prohibit a fund from investing in an acquiring fund beyond the limits of section 12(d)(1).[263] Proposed rule 12d1–4 would provide that a fund relying on section 12(d)(1)(G) of the Act or on rule 12d1–4 may not acquire the outstanding voting securities of a fund that discloses in its registration that it may be an acquiring fund under the rule 12d1–4 in excess of the limits in section 12(d)(1)(A). Hence, proposed rule 12d1–4 would limit funds' investment flexibility by limiting multi-tier structures that are formed when a fund invests in an acquiring fund.

Third, 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. The rescission of the current exemptive orders could limit funds' investment flexibility in two possible ways. To the extent that a fund relying on section 12(d)(1)(G) invests in an acquired fund that then invests in underlying funds in reliance on an exemptive order, the rule proposal could require the section 12(d)(1(G) acquiring fund to change its investment. Alternatively, funds relying on section 12(d)(1)(G) could invest in the same acquired funds, but those acquired funds would be required to reduce their investments in other funds up to the limits of sections 12(d)(1)(A) of the Act. Our analysis shows no three-tier structures created in reliance on 12(d)(1)(G) and our exemptive orders that would be affected by the rescission of our exemptive orders. Nevertheless, our analysis is limited by data availability and hence potentially could underestimate the number of affected parties.

Fourth, the rescission of rule 12d1–2 would have a similar effect as the rescission of the exemptive orders on multi-tier structures for which the top-tier fund relies on section 12(d)(1)(G).[264] In particular, the rescission of rule 12d1–2 would force certain acquiring funds that currently rely on section

[259] *See* section II.A. for a detailed list of permissible acquiring and acquired funds under current exemptive relief.

[260] In particular, as proposed, we estimate that it could take up to 10 months for an acquiring fund that fully unwinds its investment in an acquired fund, if that fund holds 25% of the outstanding shares of the acquired fund (*i.e.,* up to the control limit), and must comply with the proposed rule's 3% redemption limit. Acquiring funds that meet the control exceptions in proposed rule 12d1–4(b)(1)(iii) could hold more than 25% of an acquired fund's outstanding securities and would require additional time to unwind their investment in an acquired fund.

[261] In this and subsequent analysis, we assume that all 4,342 acquiring funds identified in Table 1 above would rely on proposed rule 12d1–4 to invest in other registered funds or BDCs beyond the limits of section 12(d)(1), and thus would be subject to the proposed rule's conditions. To the extent that our analysis overestimates the number of acquiring funds that would rely on proposed rule 12d1–4, our analysis potentially overestimates the economic impacts of the proposed rule. We are unable to estimate the number of acquiring funds that would rely on proposed rule 12d1–4 because of data limitations and because we are unable to anticipate how acquiring funds may change their investment strategies in response to the proposed rule.

[262] The percentage of fund redemptions that are above the 3% limit in any 30-day period is expected to be different than the reported statistics during periods of high volatility or decreasing asset prices. As a robustness test, we examine fund redemptions between October 2007 and March 2009 (*i.e.,* a period with high volatility and decreasing asset prices), and find that 1.36% (0.4%) of the redemptions of listed (unlisted) acquired fund shares exceeded the 3% redemption limit. *See supra* footnote 125 for a description of the methodology used to estimate fund redemptions.

[263] For example, a fund could rely on section 12(d)(1)(G) to invest in an acquiring fund and that fund, in turn, could invest in another fund in reliance on an exemptive order.

[264] The rescission of rule 12d1–2 would not affect the investment flexibility of funds that currently rely on section 12(d)(1)(G) and rule 12d1–2 to structure two-tier funds of funds because funds could rely on proposed rule 12d1–4 to structure the same two-tier funds of funds. Funds that would continue to rely on section 12(d)(1)(G) would no longer be able to acquire securities of other funds that are not part of the same group of investment companies or invest directly in stocks, bonds, and other securities.

We estimate that there are 1,055 acquiring funds that rely on section 12(d)(1)(G) and rule 12d1–2 to invest in funds that are part of the same group of investment companies beyond the limits of section 12(d)(1) as of June 2018. *See supra* footnote 244 for identification methodology of 12(d)(1)(G) funds. Our methodology may overestimate the number of acquiring funds that rely on section 12(d)(1)(G) because our data does not allow us to differentiate between funds that rely on section 12(d)(1)(G) and funds that rely on an exemptive order to invest in funds that are part of the same group of investment companies beyond the limits of section 12(d)(1). Under the rule proposal, a fund relying on section 12(d)(1)(G) would still have flexibility to invest in money market funds that are not part of the same group of investment companies in reliance on the proposed amendments to rule 12d1–1.

12(d)(1)(G) to instead rely on proposed rule 12d1–4, and thus comply with the complex structures condition of the proposed rule. As a result, either the top-tier or the middle-tier acquiring funds could be required to change their portfolio to ensure compliance with the proposed rule. As mentioned above, our analysis shows no three-tier structures—where the top-tier fund relies on section 12(d)(1)(G) and the middle-tier fund relies on exemptive orders to invest in other funds beyond the limits of section 12(d)(1)—that would be required to modify their investments.

To the extent that the rule proposal would require some existing funds of funds to change their portfolios to ensure compliance with the rule proposal, portfolio changes could: (i) Impose transaction costs on acquiring funds; (ii) force acquiring funds to sell the shares of acquired funds at potentially depressed prices; (iii) disrupt the acquiring funds' investment strategy; (iv) impose liquidity demands on acquired funds as a result of the acquiring fund redemptions; and (v) have tax implications, which would depend on whether the acquiring fund would sell appreciated or depreciated shares of acquired funds. Any negative effects on acquired funds' liquidity or investment strategy as a result of the proposed rule's conditions potentially may be more pronounced for acquired funds that are not part of a group of investment companies. Academic literature suggests that funds tend to provide liquidity to affiliated funds that face liquidity shocks.[265] Any costs of portfolio changes would be mitigated by the fact that funds would be granted one year to bring their operations in compliance with the rule proposal.

We request comment on the following:

- Are there any three-tier structures created in reliance on 12(d)(1)(G) and our exemptive orders that would be affected by the rescission of our exemptive orders and the proposed conditions in rule 12d1–4?
- Are there any three-tier structures created in reliance on 12(d)(1)(G) and our exemptive orders that would be affected by the rescission of rule 12d1–2 and the proposed conditions in rule 12d1–4?

[265] Bhattacharya et al. 2013 shows that affiliated funds of funds ''provide an insurance pool against liquidity shocks to other funds in the family'' (Utpal Bhattacharya, Jung H. Lee, & Veronika K. Pool, *Conflicting Family Values in Mutual Fund Families,* 68 J. of Fin., 173 (Feb. 2013)).

b. Eliminate Need To Apply for Exemptive Order

In return for meeting certain conditions, proposed rule 12d1–4 would permit prospective acquiring funds to acquire the securities of other funds beyond the limits of section 12(d)(1)(A) of the Act without the expense and delay of obtaining an exemptive order.[266] Assuming that the number of exemptive orders granted by the Commission would stay the same absent the proposed rule, we estimate that by removing the need to obtain an exemptive order, the proposed rule would eliminate annual aggregate administrative costs to prospective acquiring and acquired funds of approximately $5,400,000 relative to the baseline.[267] Any direct administrative cost savings arising from removing the need to apply for an exemptive order are likely limited by the fact that each exemptive order can be used by multiple funds within the same fund complex and the costs of the exemptive order application process are one-time costs. Any cost savings to prospective acquiring and acquired funds derived from eliminating the need to apply for an exemptive order likely would be more pronounced for smaller funds because 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.

The proposed rule also would 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 2017 was 377 (321) days.[268] If funds were not required to apply for an exemptive order, prospective acquiring funds would not be required to forgo investments in other funds while awaiting exemptive relief, which ultimately would increase the efficient allocation of fund assets because funds would be able to better determine the timing of their investments in other funds. Further, if the delay associated with the exemptive order process were removed, prospective acquiring funds would be able to bring new products to the market faster, which would expand investors' investment opportunities. Prospective acquired funds also would benefit because the acquiring funds' investments in them would increase their assets more quickly, and as a result the acquired funds could achieve economies of scale more quickly, ultimately benefitting the existing shareholders of the acquired funds.

The proposed rule also would remove the uncertainty associated with the exemptive order process. The exemptive order process presents uncertainties for funds because both the probability of obtaining an exemptive order and the exact terms of the exemptive order are uncertain. Uncertainty related to the exemptive order process may make funds more cautious when investing, thus potentially suppressing fund investment and growth.[269] Nevertheless, the effects of the proposed rule on uncertainty likely would 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 if prospective funds pass these savings 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 funds would pass to investors a higher percentage of cost savings arising from the proposed rule. Conversely, if the level of competition is low, fund advisers, sponsors, and other service providers would retain a higher percentage of cost savings arising from the proposed rule rather than passing these cost savings to investors. Academic literature provides conflicting evidence regarding the level of

[266] Existing funds of funds that currently rely on exemptive orders that provide relief similar to proposed rule 12d1–4 have already incurred the cost of the exemptive order process. Hence, these funds would not benefit from eliminating the need to apply for an exemptive order under proposed rule 12d1–4.

[267] In 2017, the Commission granted 14 non-ETF fund of funds orders and 40 ETF fund of funds orders (*see, supra* footnote 253 for the source of the exemptive order data). Hence, the proposed rule could result in annual aggregate administrative cost savings to funds of funds equal to $5,400,000, *i.e.,* $5,400,000 = (14 non-ETF fund of funds orders + 40 ETF fund of funds orders) × $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 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 proposing release. *See* 2018 ETF Proposing Release, *supra* footnote 34, at n. 206.

[268] *See supra* footnote 253 for the source of the exemptive order data.

[269] Academic literature provides evidence consistent with the idea that uncertainty has negative effects on investment and growth. *See, e.g.,* Nick Bloom, Stephen Bond, & John Van Reenen, *Uncertainty and Investment Dynamics,* 74 Rev. of Econ. Stud., 391 (Apr. 2007); Nicholas Bloom, *The Impact of Uncertainty Shocks,* 77 Econometrica, 623 (May 2009); Scott R. Baker, Nicholas Bloom, & Steven J. Davis, *Measuring Economic Policy Uncertainty,* 131 The Q. J. of Econ., 1593 (Nov. 2016).

competition in the fund industry. On one hand, a number of papers provide some evidence that the U.S. fund industry is competitive and that higher competition in the fund industry is associated with lower fund fees and expenses.[270] On the other hand, a number of papers suggest that price competition is not prevalent in the fund industry.[271] 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 on fees, but instead compete on performance and services.

Further, the cost savings to prospective funds of avoiding the exemptive order process under proposed rule 12d1–4 could potentially increase the number of funds of funds available to investors.[272] The Commission granted 14 non-ETF fund of funds orders and 40 ETF fund of funds orders in 2017.[273] We are unable to estimate the number of new funds of funds that would be created following the potential adoption of the proposed rule, but we believe that the number of new funds of funds would be higher than the number of funds of funds that were created as a result of the exemptive orders granted in 2017.

Academic research suggests that investment decisions are sensitive to the number of available investment opportunities.[274] Hence, investor demand for funds of funds could increase as a result of the increased number of funds of funds under the proposed rule. As an alternative to investing in funds of funds, investors could meet their investment objectives by assembling a portfolio of funds through discretionary or non-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 could represent an efficient alternative to such a strategy because fund of funds investors can avoid minimum investment requirements, can invest in funds that have been closed to new investors, can invest in funds that are restricted to a particular investor type, can avoid certain transaction costs, and can enjoy lower recordkeeping and monitoring costs relative to investors that directly invest in multiple funds.[275] As a result, the entry of new funds of funds could increase investor demand for funds of funds because it would 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.

c. New and Omitted Conditions

Proposed rule 12d1–4 would include new conditions relative to the conditions in our current exemptive orders, and would omit certain conditions contained in our exemptive orders that are no longer necessary in light of the new conditions of proposed rule 12d1–4. The new conditions of proposed rule 12d1–4 are designed to limit the acquiring funds' undue influence over the acquired funds, limit the creation of complex fund structures, and limit duplicative and excessive fees for acquiring fund investors. We discuss the benefits and costs of each of the new and omitted conditions of proposed rule 12d1–4 in detail below.

Undue Influence—Voting condition. Proposed rule 12d1–4 allows both investment companies and all other members of the acquiring fund advisory group to either use pass-through or mirror voting for acquired funds that are closed-end funds.[276] In contrast, the exemptive orders only allow investment companies to either use pass-through or mirror voting, but require any other member of the acquiring fund advisory group to use mirror voting for acquired funds that are closed-end funds. The economic effects of proposed rule 12d1–4 for acquired funds that are closed-end funds are likely immaterial because both investment companies and all other members of the acquiring fund advisory group are already restricted in their ability to vote under our current exemptive orders by being required to use pass-through or mirror voting.

Acquiring funds that hold shares of funds that are not closed-end funds would be required to use pass-through or mirror voting more frequently under proposed rule 12d1–4 relative to the exemptive orders because: (i) Pass-through or mirror voting is required at a lower ownership level under proposed rule 12d1–4 and (ii) the requirement for pass-through or mirror voting is unconditional under proposed rule 12d1–4.[277]

The more frequent use of pass-through or mirror voting for acquiring

[270] *See, e.g.,* John C. Coates, IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy,* Harvard L. & Econ. Discussion Paper No. 592 (Aug. 2007); Sunil Wahal & Albert (Yan) Wang, *Competition among Mutual Funds,* 99 J. of Fin. Econ., 40 (Jan. 2011); Ajay Khorana & Henri Servaes, *What Drives Market Share in the Mutual Fund Industry,* 16 Rev. of Fin., 81 (Oct. 2011); Burton G. Malkiel, *Asset Management Fees and the Growth of Finance,* 27 J. of Econ. Persp., 97 (Spring 2013). Further, an ICI April 2018 study suggests that the fund of funds industry is competitive: ''Strong asset growth and competitive pressures, fueled by individuals saving for retirement and new target date mutual fund entrants, continue to put downward pressure on target date mutual fund expense ratios.'' (*See supra* footnote 252, p. 28).

[271] For example, Freeman and Brown (2001) argue that there is lack of price competition in the fund industry (John P. Freeman & Steward L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest,* 26 The J. of Corp. L., 609 (Spring 2001)). Further, Barber et al. (2005) find no relation between fund operating expenses and fund flows (Brad M. Barber, Terrance Odean, & Lu Zheng, *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows,* 78 J. of Bus., 2095 (Nov. 2005)). Gil-Bazo and Ruiz-Verdú (2009) shows that funds with worse before-fee performance charge higher fees (Javier Gil-Bazo & Pablo Ruiz-Verdú, *The Relation between Price and Performance in the Mutual Fund Industry,* 64 J. of Fin., 2153 (Oct. 2009)).

[272] Our analysis identified no acquiring BDCs as of June 2018. We expect that the effect of the rule proposal 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 37).

[273] *See supra* footnote 267.

[274] *See* Benartzi and Thaler (2001) presenting survey evidence and plan-level statistics that support the idea that retirement plan investors practice ''1/n'' diversification across all available investment alternatives (Shlomo Benartzi & Richard H. Thaler, *Naive Diversification Strategies in Defined Contribution Saving Plans,* 91 a.m. Econ. Rev., 79 (Mar. 2001)). But, Huberman and Jiang (2006) demonstrate 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 (Gur Huberman & Wei Jiang, *Offering versus Choice in 401(k) Plans: Equity Exposure and Number of Funds,* 61 J. of Fin., 763 (Apr. 2006)).

[275] *See, e.g.,* Elton et al. (2015), which shows that ''additional expenses charged by TDFs are largely offset by the low-cost share classes they hold, not normally open to their investors'' (Edwin J. Elton, Martin J. Gruber, Andre de Souza, & Christopher R. Blake, *Target Date Funds: Characteristics and Performance,* 5 Rev. of Ass. Pric. Stud., 254 (May 2015)).

[276] The voting provisions for separate accounts in the proposed rule would be the same as the voting provisions in section 12(d)(1)(E)(iii)(aa) of the Act, which we believe most insurance product separate accounts already comply with. Thus, we do not believe the voting provisions for separate accounts would have an economic impact.

[277] The current exemptive orders require pass-through or mirror voting if an acquiring fund and its advisory group, in the aggregate, hold more than 25% of the acquired fund's outstanding voting securities as a result of a decrease in the outstanding voting securities of an acquired fund, but the proposed rule would require pass-through or mirror voting whenever the acquiring fund and its advisory group own more than 3% of the acquired fund's outstanding voting securities.

funds that hold shares of funds that are not closed-end funds under proposed rule 12d1–4 could limit the ability of acquiring funds to exercise undue influence over the acquired funds.

At the same time, the more frequent use of pass-through or mirror voting for acquiring funds that hold shares of funds that are not closed-end funds could increase distortions in the voting process. In particular, pass-through and mirror voting requirements can decrease the voting power of acquiring funds and consequently increase the voting power of the remaining acquired fund shareholders, potentially introducing distortions in the voting process. We expect that the distortive effect of mirror voting could be more pronounced than the distortive effect of pass-through voting because pass-through voting allows the acquiring fund to vote in accordance with the instructions of its shareholders while mirror voting requires the acquiring fund to vote in the same proportion as the vote of all other holders of the acquired fund shares, which effectively nullifies the voting power of the acquiring fund. The economic effect of any distortions in the voting process is unclear ex-ante and would 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 shareholders (*e.g.,* retail versus institutional investors); [278] and (iii) how frequently votes are close and so the acquiring fund's voting could determine the outcome of the vote.

At the same time, the more frequent use of pass-through or mirror voting under proposed rule 12d1–4 relative to the exemptive orders for acquired funds that are not closed-end funds would impose voting restrictions on acquiring funds, and thus could reduce funds' incentives to acquire large blocks of shares and potentially support value-increasing actions through their voting.[279]

An additional cost of the voting provision of proposed rule 12d1–4 for acquired funds that are not closed-end funds is that acquiring funds would be required to more frequently engage in pass-through or mirror-voting and incur the associated costs. We estimate that all funds subject to the voting provision of proposed rule 12d1–4 would incur a one-time burden to update their proxy voting policies and related voting disclosures to reflect that the fund is subject to the voting provisions of the proposed rule. This one-time burden would be equal to $6,246 per fund and would result in an aggregate one-time burden equal to $5,053,014.[280] We estimate that each year after the adoption of the proposed rule, mirror voting by acquiring funds subject to the voting condition would impose an aggregate annual ongoing burden of $4,499,165.[281] Pass-through voting by acquiring funds would impose an aggregate annual ongoing burden equal to $907,776.[282] Funds potentially could pass any higher administrative costs associated with the new voting provisions to their shareholders in the form of higher operating expenses. Any such additional administrative costs would be partially mitigated by the fact that funds currently relying on exemptive orders already have in place policies and procedures to implement pass-through and mirror voting.[283]

The voting provisions of proposed rule 12d1–4 are more streamlined than the voting provisions under our current exemptive orders because the same voting provisions apply for both closed-end and other types of acquired funds, and the same voting provisions apply regardless of whether the voting party is an investment company or not.[284] Untabulated analysis shows that as of June 2018, out of the 4,342 acquiring funds, 809 hold more than 3% of an acquired fund's outstanding shares.[285] Hence, we expect that the proposed rule's pass-through and mirror voting provisions could be binding in certain circumstances.

We request comment on the following:

- How do funds currently cast their votes in shareholder meetings? What is the cost of the current voting procedures? What are the determinants of the costs of the current voting procedures? Please provide a breakdown of the costs of the current voting procedures by type of cost.
- What is the initial and ongoing cost of a mirror voting procedure? What are the determinants of the costs of mirror voting? Do funds currently have in place procedures for mirror voting? How frequently is mirror voting currently used by funds? Please provide a breakdown of the costs for mirror voting by type of cost.
- What is the initial and ongoing cost of a pass-through voting procedure? What are the determinants of the costs of pass-through voting? Do funds currently have in place procedures for

[278] There are large differences in voting involvement by institutional investors compared to retail investors (*see, e.g.,* Broadridge and PwC, 2018, ProxyPulse: 2018 Proxy Season Review, available at *https://www.broadridge.com/_assets/pdf/broadridge-2018-proxy-season-review.pdf*).

[279] 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 Funds and Shareholder Activism,* 49 J. of Fin. and Quant. An., 1311 (Oct./Dec. 2014); Michael Bradley, Alon Brav, Itay Goldstein, & Wei Jiang, *Activist Arbitrage: A Study of Open-Ending Attempts of Closed-End Funds,* 95 J. of Fin. Econ., 1 (Jan. 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. of Fin., 2933 (Dec. 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. of Fin. and Quant. An., 567 (Jun. 2012); Gerald F. Davis, & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds,* 85 J. of Fin. Econ., 552 (Aug. 2007)). There is some evidence, however, of increased activism by funds, other than hedge funds, over time (*see, e.g.,* J.P. Morgan, *The 2017 Proxy Season: Globalization and a New Normal for Shareholder Activism,* available at *https://www.jpmorgan.com/jpmpdf/1320739681811.pdf*).

[280] This estimate is based on the following calculation: $5,053,014 = ($1,176 one-time internal burden + $5,070 one-time external burden) × 809 acquiring funds. *See infra* footnotes 350 and 353.

[281] This estimate is based on the following calculation: $4,499,165 = ($1,176 ongoing annual internal burden + $400 ongoing annual external burden) × 793 acquiring funds × 3.6 mirror votes per year. *See infra* footnotes 354, 356, and 358.

[282] This estimate is based on the following calculation: $907,776 = ($11,760 ongoing annual internal burden + $4,000 ongoing annual external burden) × 16 acquiring funds × 3.6 pass-through votes per year. *See infra* footnotes 355, 357, and 359.

[283] We expect that certain funds that currently rely on section 12(d)(1)(G) and rule 12d1–2 to invest in funds that are part of the same group of investment companies beyond the limits of section 12(d)(1) would rely on proposed rule 12d1–4 following the potential adoption of the rule proposal. Those funds would incur the administrative costs to set up policies and procedures to implement pass-through and mirror voting because they currently do not have in place these policies and procedures. We estimate that there are 1,055 acquiring funds that rely on section 12(d)(1)(G) and rule 12d1–2 to invest in funds that are part of the same group of investment companies beyond the limits of section 12(d)(1) as of June 2018 (*see supra* footnote 264). We are unable to estimate how many of those funds would decide to rely on proposed rule 12d1–4 to invest in funds that are part of the same group of investment companies beyond the limits of section 12(d)(1) because of data limitations and complexity and uncertainty of such an estimate. We are also unable to estimate the extent to which the costs of developing policies and procedures to implement pass-through and mirror voting would reduce fund incentives to rely on proposed rule 12d1–4 instead of section 12(d)(1)(G) and amended rule 12d1–1.

[284] The voting provisions of proposed rule 12d1–4 are 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 controlling, controlled by, or under common control with such investment sub-adviser acts as the acquired fund's investment adviser or depositor (*see supra* section II.C.1.b).

[285] Due to data limitations we use total rather than voting shares outstanding for this analysis. Data is retrieved from Morningstar Direct and Morningstar Investment Company Holdings databases.

pass-through voting? How frequently is pass-through voting currently used by funds? Please provide a breakdown of the costs for pass-through voting by type of cost.

- What are the initial and ongoing costs of mirror voting procedures for funds that rely on sections 12(d)(1)(E) and (F)? What are the initial and ongoing costs of pass-through voting procedures for funds that rely on sections 12(d)(1)(E) and (F)? Are there any funds other than those that rely on exemptive orders and sections 12(d)(1)(E) and (F) that implement pass-through or mirror voting procedures?
- Are there any economic effects associated with the voting provisions of proposed rule 12d1–4 that are not discussed in this section? What are these effects? Is there any data available to estimate the magnitude of these effects? For example, is there any data on the extent to which pass-through votes are actually voted?
- Would funds choose to use mirror voting over pass-through voting or the other way around under proposed rule 12d1–4? What would determine this decision?
- How many of the funds that currently rely on section 12(d)(1)(G) and rule 12d1–2 to invest in funds that are part of the same group of investment companies beyond the limits of section 12(d)(1) would rely on proposed rule 12d1–4 following the potential adoption of the rule proposal?

Undue Influence—Redemption limit. To prevent overreaching and undue influence, current exemptive orders typically require that: (i) Fund boards make certain findings and adopt procedures and (ii) acquiring and acquired funds enter into participation agreements. Proposed rule 12d1–4 would replace these conditions with the requirement that acquiring funds cannot redeem or tender for repurchase more than 3% of the acquired fund's voting shares in any 30-day period.

Omitting the board and participation agreement requirements contained in our current exemptive orders would result in cost savings for funds. We estimate that implementing and monitoring compliance with the conditions associated with acquiring and acquired funds' findings and procedures takes 10 internal burden hours of acquiring and acquired funds' staff time each year, monetized to an annual burden of $3,892, and imposes an external annual cost of $5,470 per acquiring or acquired fund.[286] Accordingly, by eliminating these conditions, we estimate aggregate annual internal cost savings of $14,240,828 for existing acquiring funds and $9,811,732 for existing acquired funds under the proposed rule, as well as aggregate external cost savings of $20,014,730 for existing acquiring funds and $13,789,870 for existing acquired funds.[287]

Additionally, we estimate that negotiating the terms and entering into a participation agreement would initially cost each fund between $6,000 and $12,000. We also estimate that, on average, each acquiring fund enters into participation agreements with 3 new acquired funds each year. Accordingly, we estimate that existing acquiring and acquired funds would realize an aggregate initial annual cost savings of $98,793,000 as a result of the proposed rule's elimination of the need to draft participation agreements.[288] In addition, funds would no longer incur the costs associated with implementing the terms and monitoring compliance with participation agreements. We estimate that for each fund the ongoing costs are half of the initial one-time cost of negotiating the terms and entering into a participation agreement. Hence, the annual cost savings for acquiring and acquired funds as a result of eliminating the need to implement the terms and monitor compliance with the participation agreements would be approximately $181,120,500.[289]

By omitting the participation agreement requirement, proposed rule 12d1–4 also could limit acquired funds' ability to block the acquisition of their shares by certain acquiring funds by refusing to enter into participation agreements with those funds.[290] Restricting the ability of funds to decide on who invests in them could have a negative effect on acquired funds' performance, assuming that acquired funds would no longer be able to block the acquisition of their shares by certain acquiring funds that they believe may exercise undue influence over them. Nevertheless, other provisions of proposed rule 12d1–4, such as the redemption limit, would mitigate the risk that acquiring funds could exercise undue influence over acquired funds under proposed rule 12d1–4. At the same time, restricting the ability of funds to determine which acquiring funds may invest in them could have a positive effect on acquired funds' performance, assuming that acquired funds otherwise would block activist investors, who could have a positive effect on acquired funds' governance and operations, and thus have a positive effect on fund performance.[291]

[286] This 10 hour estimate is based on our analysis, which shows that each acquiring fund invests, on average, in 12 acquired funds and each acquired fund has sold its shares, on average, to 17 acquiring funds. To estimate the average number of acquired and acquiring funds, we use the investments of 3,659 acquiring funds (*i.e.,* 4,342 acquiring funds from Table 1 above less 683 acquiring funds that solely invest in unregistered acquired funds) in 2,521 acquired funds (*i.e.,* 2,521 acquired funds from Table 1 above) because only registered investment companies and BDCs that invest in other registered investment companies and BDCs beyond the limits of section 12(d)(1) are currently required to enter into participation agreements under our exemptive orders. *See also supra* section II.A. for an overview of the types of arrangements that have been permitted by our exemptive orders.

[287] These estimates are based on the following calculations:

For internal costs, 4 hours × $317 hourly rate for a senior portfolio manager = $1,268; 4 hours × $480 blended hourly rate for an assistant general counsel ($449) and a chief compliance officer ($511) = $1,920; 2 hours × $352 hourly rate for a compliance attorney = $704. $1,268 + $1,920 + $704 = $3,892; $3,892 × 3,659 acquiring funds = $14,240,828 and $3,892 × 2,521 acquired funds = $9,811,732. *See supra* footnote 286 (describing the estimate of 3,659 affected acquiring funds).

For external costs, 1 hour × $400 hourly rate for outside counsel = $400 and 1 hour × $5,070 hourly rate for board of directors = $5,070. $400 + $5,070 = $5,470; $5,470 × 3,659 acquiring funds = $20,014,730 and $5,470 × 2,521 acquired funds = $13,789,870.

In this and subsequent analysis, our estimates may overestimate cost savings because we assume that all existing acquiring funds that invest in at least one registered fund or BDC and all acquired registered funds and BDCs currently rely on exemptive orders, and would rely on proposed rule 12d1–4.

Our estimates of the relevant wage rates 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 1800-hour work-year and multiplied by 5.35 (professionals) or 2.93 (office) 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'').

[288] These estimates are based on the following calculations: 3 new acquired funds × 3,659 acquiring funds × ($6,000 + $12,000)/2 average cost of negotiating the terms and entering into a participation agreement = $98,793,000. *See supra* footnote 286 (describing the estimate of 3,659 affected acquiring funds). The cost savings brought by eliminating the need to draft a participation agreement only accrue to prospective acquiring-acquired fund pairs because funds in existing acquiring-acquired fund relationships have already incurred the cost of drafting a participation agreement.

[289] This estimate is based on the following calculation: 3,659 acquiring funds × 11 acquired funds that an acquiring fund invests in on average × ($6,000 + $12,000)/2 average cost of negotiating the terms and entering into a participation agreement × 0.5 of the cost of negotiating the terms and entering into a participation agreement = $181,120,500. *See supra* footnote 286 (describing the estimate of 3,659 acquiring funds).

[290] Under proposed rule 12d1–4, acquiring funds could still block the acquisition of their shares by all other funds by disclosing in their registration statements that they may be acquiring funds.

[291] *See supra* footnote 279.

The redemption limit would protect acquired funds from the undue influence that acquiring funds could exercise over them through the threat of large-scale redemptions. However, the redemption limit would impose several costs on acquiring funds. First, the redemption limit would impose one-time and ongoing costs on acquiring funds because the funds would be required to monitor their fund redemptions to ensure that they do not violate the 3% redemption limit. The one-time costs could include: (i) Developing policies and procedures to ensure compliance with the redemption limit; (ii) planning, coding, testing, and installing system modifications to ensure compliance with the limit; (iii) integrating and implementing policies and procedures related to the redemption limit; and (iv) preparing training materials and administering training sessions for staff in affected areas. The ongoing costs include: (i) Continuous monitoring of fund redemptions and the percentage of acquired fund shares that the acquiring fund owns; (ii) periodic review of the policies and procedures put in place to monitor the redemption limit; (iii) system maintenance; and (iv) additional staff training. We estimate that the one-time internal hour burden of the redemption limit would be equal to 253 hours for each fund, monetized at $102,936, which would result in an aggregate internal burden of 1,098,526 hours, monetized at $446,948,112 for all acquiring funds.[292] We also estimate that the ongoing internal burden of the redemption limit would be equal to 20% of the initial burden of the redemption limit and thus would result in an aggregate ongoing annual internal burden of 219,705 hours, monetized at $89,389,622.[293] Further, we estimate that the one-time external cost of the redemption limit would be equal to $101,400 for each fund, which would result in an aggregate external cost of $440,278,800 for all acquiring funds.[294] We also estimate that the ongoing annual external cost of the redemption limit would be equal to 20% of the initial external cost of the redemption limit, and thus would result in an aggregate ongoing annual external cost of $88,055,760.[295]

Second, the proposed rule's redemption limit could impose liquidity constraints on current and prospective acquiring funds because acquiring funds would be unable to quickly liquidate their investments in other funds.[296] In particular, assuming that an acquiring fund would hold up to 25% of the outstanding shares of an acquired fund (*i.e.,* control limit) and assuming it would only be allowed to redeem 3% of the acquired fund shares in every 30-day period (*i.e.,* redemption limit), it would take the acquiring fund 10 months to fully unwind its investment in the acquired fund, assuming no other concurrent changes in the number of acquired fund shares that are unrelated to the acquiring fund's redemptions. Between January 2017 and June 2018, 0.76% (0.16%) of the redemptions of listed (unlisted) acquired fund shares exceeded the 3% redemption limit.[297] Hence, fund redemptions in excess of 3% in any 30-day period during this 18-month sample period are not frequent. However, we acknowledge that this condition could have a larger impact during periods of decreasing prices or high volatility.[298] In addition, as of June 2018, 809 of the 4,342 acquiring funds hold over 3% of the outstanding shares of at least one acquired fund, and thus would be affected by the proposed rule's redemption limit. Any negative effects on acquiring funds' liquidity as a result of the proposed rule's redemption limit would potentially be more pronounced for acquiring funds that do not belong to a fund complex. The reason is that academic literature shows that funds tend to provide liquidity to affiliated funds in the event of adverse liquidity shocks.[299]

Third, the redemption limit could affect funds' investments for the following reasons. The proposed redemption limit would be more binding for acquiring funds that hold unlisted versus listed funds because acquiring funds can dispose of their investments in listed acquired funds in the secondary market without regard for the redemption limit. Hence, as a result of the proposed rule, acquiring funds would likely favor investments in listed over unlisted acquired funds. 41% of the acquired funds (in terms of total gross assets) are currently listed on national securities exchanges. In addition, acquiring funds may favor investments in larger acquired funds because it would be easier to stay below 3% of the acquired fund's outstanding securities and thus not trigger the 3% redemption limit when investing in larger rather than smaller acquired funds.[300]

Lastly, the redemption limit could affect acquiring funds' investments in affiliated funds. Currently, acquiring funds can rely on section 12(d)(1)(G) and rule 12d1–2 to invest in affiliated funds beyond the limits of section 12(d)(1) without a limit on fund redemptions. Following the proposed rescission of rule 12d1–2, some of these acquiring funds could decide to rely on proposed rule 12d1–4 to preserve their investment flexibility. These acquiring funds would be required to comply with

[292] This estimate is based on the following calculation: 115 hours × $324 hourly rate for a senior portfolio manager + 115 hours × blended hourly rate for assistant general counsel ($458) and chief compliance officer ($521) + 23 hours × $408 hourly rate for fund attorney time = $102,936 of one-time cost of redemption limit per fund; 1,098,526 hours = 4,342 acquiring funds × 253 hours of internal burden of redemption limit per fund; $446,948,112 = 4,342 acquiring funds × $102,936 of one-time cost of redemption limit per fund. *See supra* footnote 287 for the source of salary data.

This figure overestimates the total one-time cost associated with the redemption limit because it assumes each acquiring fund would incur these costs on an individual basis. These costs, however, likely would be allocated among multiple acquiring funds within a fund complex. In addition, this figure overestimates the total one-time cost associated with the redemption limit because it includes acquiring funds that rely on proposed rule 12d1–4 solely to purchase and sell acquired fund shares in secondary market transactions. The redemption limit would not apply to secondary market transactions in acquired fund shares.

[293] These estimates are based on the following calculations: 219,705 hours = 20% × 1,098,526 initial hour burden of redemption limit. $89,389,622 = 20% × $446,948,112 of aggregate one-time internal cost of redemption limit.

[294] These estimates are based on the following calculations: 20 hours × $5,070 hourly rate for board of directors = $101,400; 4,342 acquiring funds × $101,400 = $440,278,800.

[295] This estimate is based on the following calculation: $88,055,760 = 20% × $440,278,800 of aggregate one-time external cost of redemption limit.

[296] The impact of the redemption limit on acquiring funds' ability to redeem their investments in other funds could be exacerbated during periods of large fund outflows. In particular, large fund redemptions would decrease the acquired funds' shares outstanding. This decrease in the acquired funds' shares outstanding would further restrict acquiring funds' ability to redeem their investments in acquired funds because the redemption limit is expressed in terms of the acquired funds' shares outstanding. At the same time, the redemption limit could have a positive effect on acquired funds' liquidity because it would slow fund outflows. This positive effect of the redemption limit on acquired funds could be particularly important during periods of poor performance when fund outflows are more pronounced and the risk that acquiring funds exercise undue influence over the acquired fund through the threat of large scale redemptions is also more pronounced.

[297] The frequency for acquiring funds that redeem more than 0.5%, 1%, and 5% of the shares of acquired funds that are listed (are not listed) on an exchange is 4.11%, 2.18%, and 0.40% (0.61%, 0.37%, and 0.07%), respectively.

[298] *See supra* footnote 262 for descriptive statistics on fund redemptions between October 2007 and March 2009 (*i.e.,* a period with high volatility and decreasing asset prices).

[299] *See supra* footnote 265.

[300] Any decrease in the attractiveness of open-end funds as acquired funds because they are unlisted would be mitigated at least partially by an increase in the attractiveness of open-end funds as acquired funds because open-end funds are larger than most registered funds and thus acquiring funds' holdings in open-end funds are less likely to violate the 3% limit of the redemption condition.

the proposed rule's redemption limit, which would apply to their investments in both affiliated and unaffiliated acquired funds. As a result, these acquiring funds may decide to reduce the proportion of their assets invested in affiliated acquired funds to mitigate the cost of the redemption limit.[301]

Fourth, the redemption limit could distort the prices of the underlying securities of the acquired funds by limiting the acquiring funds' ability to sell shares.[302] In particular, the redemption limit could moderate the trading activity of informed traders with negative information, slowing the flow of negative new information to the market, and thus reducing the speed of price discovery and creating temporary deviations of prices from their fundamental values.

Fifth, the control, voting, and redemption conditions in proposed rule 12d1–4 are designed to prevent an acquiring fund from being able to unduly influence an acquired fund, while the provisions in our exemptive orders target certain instances where an acquiring fund may seek to influence an acquired fund (*e.g.,* purchase shares in underwritings in which an affiliate of the acquiring fund is the principal underwriter). We believe that the conditions in the proposed rule provide protection against a broader set of circumstances than the targeted and prescriptive provisions in our exemptive orders and therefore would enhance investor protection. On the other hand, to the extent that the provisions of the proposed rule would not provide protection against all sets of circumstances that the provisions in our exemptive orders explicitly provide protection against, the proposed rule could weaken investor protection.

In addition, the fact that the redemption limit only applies to primary but not secondary market trading could limit the extent to which the redemption limit protects listed acquired funds from acquiring funds' undue influence because selling pressure in the secondary market could depress the prices of listed acquired funds.[303] As a result, acquiring funds could use the threat of large scale secondary market sales that could depress asset prices to exert undue influence over the acquired funds. Acquired funds could be interested in the price of their shares in the secondary market because, among other things, they potentially could be interested in raising additional capital. We believe that the risk of fund asset prices deviating from their fundamental values is mitigated by the likelihood that arbitrageurs would trade and correct such deviations in the long run. Nevertheless, literature provides some evidence of persistent deviations of fund asset prices from their fundamental values.[304]

We request comment on the following:

• Do you agree with our cost savings estimate that would arise from omitting the requirements associated with acquiring and acquired fund boards' findings and procedures? If not, please provide a cost savings estimate that would arise from omitting the requirements associated with acquiring and acquired fund boards' findings and procedures. How many hours do funds spend annually, on average, to implement and monitor compliance with the board findings and procedures required by our orders? What is the job description of each party involved in this process? What is the average hourly wage for each party involved? Do costs differ for acquiring and acquired funds? If yes, in which ways?

• Are there any economic effects that would arise from omitting the board requirements under our exemptive orders that are not discussed in the economic analysis?

• Do you agree with our cost savings estimate that would arise from omitting the requirements to negotiate the terms and enter into a participation agreement? If not, please provide a cost savings estimate for each fund that would arise from omitting the requirement to negotiate the terms and enter into a participation agreement. What is the job description of each party involved in negotiating the terms and entering into the participation agreements? What is the average hourly wage for each party involved? Into how many participation agreements does each acquiring fund enter each year on average?

• Do you agree with our cost savings estimate that would arise from omitting the requirement to implement and monitor compliance with participation agreements? If not, please provide a cost savings estimate that would arise from omitting the requirement to implement and monitor compliance with the participation agreements. What is the job description of each party involved in implementing and monitoring compliance with the participation agreements? What is the average hourly wage for each party involved?

• Are there any economic effects that would arise from omitting the requirement for acquiring and acquired funds to enter into participation agreements beyond those discussed in the economic analysis? For example, would omitting the requirement for a participation agreement change the way in which acquiring funds acquire other funds? Would acquiring funds change the frequency with which they acquire funds through intermediaries? Would such a change have any economic effects? Would acquired funds change their agreements with intermediaries?

• Are our cost estimates for the redemption limit accurate? If not, what types of one-time costs would the redemption limit impose to acquiring funds? What types of ongoing costs would the redemption limit impose to acquiring funds? Please provide an estimate for the one-time and ongoing costs of the redemption limit. What is the job description of each party involved in implementing and monitoring compliance with the redemption limit? What is the average hourly wage for each party involved?

• Is our description of the economic effects of the redemption limit accurate?

[301] The cost of the redemption limit increases with the acquiring fund's ownership of the acquired fund. Under proposed rule 12d1–4, acquiring funds are prohibited from acquiring unaffiliated funds beyond the control limit, but they may acquire an unlimited amount of shares of affiliated funds. Hence, to the extent that acquiring funds would acquire the maximum permissible amount in affiliated and unaffiliated funds, the potential cost of the redemption limit would be higher for fund investments in affiliated funds than in unaffiliated funds.

[302] Literature provides evidence that short selling constraints can harm price discovery (*see, e.g.,* Alessandro Beber & Marco Pagano, *Short-Selling Bans Around the World: Evidence from the 2007–09 Crisis,* 68 J. of Fin., 343 (Feb. 2013); Charles M. Jones & Owen A. Lamont, *Short-Sale Constraints and Stock Returns,* 66 J. of Fin. Econ., 207 (Nov./Dec. 2002)). Redemption limits could affect price discovery similar to short selling constraints because both redemption limits and short selling constraints impose limits on sales.

[303] For example, Chordia et al. (2002) show that asset prices are temporarily affected by buying and selling pressures (Tarun Chordia, Richard Roll, & Avanidar Subrahmanyam, *Order Imbalance, Liquidity, and Market Returns,* 65 J. of Fin. Econ., 111 (Jul. 2002)). Literature also shows that demand and supply shocks can result in price reactions that reverse slowly. For example, Duffie (2010) shows that price reversals following price responses to demand and supply shocks can be slow due to impediments to capital movement, such as search costs (Darrell Duffie, *Presidential address: Asset Price Dynamics with Slow Moving Capital,* 65 J. of Fin., 1237 (Aug. 2010)).

[304] *See, e.g.,* Engle and Sarkar (2006), Buetow and Henderson (2012), Madhavan and Sobczyk (2016), and Petajisto (2017) for empirical evidence on premiums and discounts for ETFs (Robert Engle & Debojyoti Sarkar, *Premiums-Discounts and Exchange Traded Funds,* 13 J. of Der., 27 (Summer 2006); Gerald W. Buetow & Brian J. Henderson, *An Empirical Analysis of Exchange-Traded Funds,* 38 J. of Port. Manag., 112 (Summer 2012); Ananth Madhavan & Aleksander Sobczyk, *Price Dynamics and Liquidity of Exchange-Traded Funds,* 14 J. of Inv. Manag., 1 (2016); Antti Petajisto, *Inefficiencies in the Pricing of Exchange-Traded Funds,* 73 Fin. Anal. J., 24 (1st Quarter 2017)).

Are there any economic effects of the redemption limit that are not discussed in the economic analysis? For example, could the redemption limit increase acquiring funds' costs to monitor their investments by forcing them to invest in multiple funds in lieu of investing in a single fund to avoid the limit on fund redemptions? Other than the parties identified in the economic analysis, please identify any other parties that could be differentially affected by the redemption limit.

- Would the redemption limit together with the control and voting provisions of proposed rule 12d1–4 appropriately protect acquired funds from acquiring funds' undue influence?

Duplicative and excessive fees. As discussed above, the current exemptive orders contain certain conditions designed to prevent duplicative and excessive fees for acquiring fund shareholders.[305] Proposed rule 12d1–4 would replace these conditions with the following conditions. For management companies, proposed rule 12d1–4 would require the acquiring fund's adviser to evaluate the complexity of the structure and the aggregate fees associated with the acquiring fund's investment in acquired funds and find that it is in the best interest of the acquiring fund to invest in acquired funds. The acquiring fund's adviser must make this finding before investing in acquired funds in reliance on the proposed rule and with such frequency as the acquiring fund's board deems reasonable and appropriate, but in any case, no less frequently than annually. The acquiring fund's adviser must report its finding and the basis for the finding to the acquiring fund's board of directors to enable the board to exercise effective oversight. Additionally, the proposed rule would require the acquiring fund to maintain and preserve a written record of the adviser's finding, the basis for the finding, and the adviser's reports to the board.

For UITs, on or before the date of initial deposit of portfolio securities into a registered UIT, the UIT's principal underwriter or depositor must evaluate the complexity of the structure and the aggregate fees associated with the UIT's investment in acquired funds, and find that the fees of the UIT do not duplicate the fees of the acquired funds that the UIT holds or will hold at the date of deposit. The proposed rule would require the acquiring fund to maintain and preserve a written record of the finding of the principal underwriter or depositor.

For separate accounts, the proposed rule would require an acquiring fund to obtain a certification from the insurance company issuing the separate account that it has determined that the fees 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 proposed rule would also require the acquiring fund to maintain and preserve a written record of each certification obtained by the acquiring fund.

We believe that omitting the requirements contained in our current exemptive orders likely would not have an economic effect. First, the FINRA sales charge rule remains applicable to certain funds of funds regardless of the proposed rule's requirements. Second, current exemptive orders require that the acquiring fund's adviser should waive advisory fees and the acquiring fund's board should make certain findings regarding advisory fees. These requirements also are part of the advisers' and boards' fiduciary duties.[306] Consequently, advisers and boards would fulfill these requirements regardless of the proposed rule's conditions.

We also believe that the fee conditions of the proposed rule might better protect acquiring fund shareholders from duplicative and excessive fees because they are broader than the requirements included in the exemptive orders. For example, the requirement in the exemptive orders that the acquiring fund board should 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 redundant in light of a fund board's fiduciary duties and statutory obligations. Under proposed rule 12d1–4, the adviser should evaluate the complexity of the fund of funds structure and also evaluate aggregate fees of all tiers in the fund of funds arrangement with an eye towards duplication. Further, the proposed rule includes a number of additional requirements that are not included in the exemptive orders and are tailored to the characteristics of certain categories of acquiring funds. For example, the proposed rule would impose different fee conditions for management companies and UITs to account for the unique characteristics of UITs.

At the same time, the fee conditions of the proposed rule would result in one-time and ongoing implementation and monitoring costs. A management company's adviser would bear one-time costs to evaluate the complexity of the structure and aggregate fees associated with the acquiring fund's investment in acquired funds. The proposed rule does not require an acquiring fund's adviser to evaluate the complexity of the structure and aggregate fees in connection with every investment in an acquired fund, and advisers may consider developing policies and procedures to evaluate the complexity of the fund of funds' structure and the aggregate fees associated with the acquiring fund's investment in acquired funds. The Commission staff estimates that the evaluations would impose an initial cost of $28,615 per fund resulting in an aggregate initial cost of $96,518,395.[307]

The ongoing costs for management companies include: (i) Advisers' initial and periodic evaluation, as frequently as required by the board, of the complexity of the structure and aggregate fees and expenses associated with their investments in acquired funds; (ii) advisers' preparation and reporting of their finding and the basis for the finding to the acquiring fund's board of directors; and (iii) the recordkeeping costs associated with maintaining and preserving a written record of the adviser's finding, the basis for the finding, and the adviser's reports to the board. The Commission staff estimates that the evaluations—including board oversight responsibilities, recordkeeping obligations, and the board engaging outside counsel to review the evaluations—would impose ongoing annual costs of $32,237 per fund resulting in an aggregate ongoing annual cost of $108,735,401.[308]

UITs' principal underwriters or depositors would bear one-time costs to evaluate the fund of funds' complexity and the aggregate fees associated with the UIT's investment in acquired funds. The one-time cost to evaluate the fund of funds' complexity and the aggregate fees would be equal to $13,405 per UIT

[305] *See supra* section VI.B.2.b.

[306] *See, e.g., supra* footnotes 148 and 149.

[307] This estimate is based on the following calculation: ($11,005 initial internal burden per management company + $17,610 initial external burden per management company) × 3,373 acquiring management companies = $96,518,395. *See* also *infra* footnotes 365 and 368.

[308] This estimate is based on the following calculation:

($2,887 ongoing internal annual burden per management company + $5,870 ongoing annual external burden per management company) × 3,373 acquiring management companies = $29,537,361. *See* also *infra* footnote 367 and 369.

(8 hours × $400 hourly rate for outside counsel + 4 hours × $5,070 hourly rate for board of directors) × 3,373 acquiring management companies = $79,198,040. *See supra* footnote 287 for the source of salary data.

$29,537,361 + $79,198,040 = $108,735,401.

resulting in an aggregate initial cost of $12,989,445.[309] Further, UITs would bear ongoing annual recordkeeping costs equal to $388 per UIT resulting in an aggregate ongoing annual recordkeeping cost of $375,972, and they would not bear any other ongoing implementation or monitoring costs because they are only required to evaluate the complexity of the structure and the aggregate fees associated with the UIT's investment in an acquired fund at the time of initial deposit.[310]

Lastly, separate accounts would bear initial recordkeeping costs equal to $310 per separate account resulting in an aggregate initial recordkeeping cost of $205,530.[311] Separate accounts also would bear ongoing recordkeeping costs equal to $78 per separate account resulting in an aggregate ongoing annual recordkeeping cost of $51,714.[312] The rest of the fee conditions in the proposed rule are the same as the requirements in the current exemptive orders, and thus they would not impose additional costs to separate accounts funding variable insurance products.

We request comment on the following:

• Do you agree with our assessment that omitting the requirements in our exemptive orders that relate to duplicative and excessive fees would not have an economic effect? If not, what economic effect do you expect this omission would have?

• Do you agree with our assessment that the duplicative and excessive fee conditions of proposed rule 12d1–4 would better protect acquiring fund shareholders from duplicative and excessive fees than the conditions in our exemptive orders? If not, why not?

• Do you agree with our cost estimates for implementation and monitoring of compliance with the duplicative and excessive fee conditions of proposed rule 12d1–4? If not, please provide a cost estimate to implement and monitor compliance with the duplicative and excessive fee conditions of proposed rule 12d1–4. What types of one-time costs would the fee conditions involve? What types of ongoing costs would the fee conditions involve (*e.g.,* recordkeeping costs)? What is the job description of each party involved in the implementation and monitoring of compliance with each fee condition of proposed rule 12d1–4? What is the average hourly wage for each party involved in the implementation and monitoring of compliance with each fee condition of proposed rule 12d1–4?

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 investing in an acquiring fund beyond the limits in section 12(d)(1). In line with the current exemptive orders, proposed rule 12d1–4 would prohibit an acquired fund from investing beyond the statutory limits in both registered funds and private funds subject to limited exceptions.[313]

The rule proposal also would expand the complex structures prohibitions included in the exemptive orders in the following ways. First, proposed rule 12d1–4 would prohibit an investment company that is relying on section 12(d)(1)(G) of the Act or proposed rule 12d1–4 from acquiring, in excess of the limits in section 12(d)(1)(A) of the Act, the outstanding voting securities of a fund that discloses in its most recent registration statement that it may be an acquiring fund in reliance on rule 12d1–4, thereby limiting fund of funds arrangements in which the acquired fund is itself an acquiring fund.[314] Second, the rescission of the current exemptive orders would result in the prohibition of multi-tier structures formed in reliance on section 12(d)(1)(G) and the exemptive orders. As discussed above, an acquiring fund relying on section 12(d)(1)(G) currently could invest in an acquired fund that invests in another fund in reliance on an exemptive order.

The rule proposal would enhance investor protection because the additional complex structures conditions included in the rule proposal would limit the creation of multi-tier structures that historically have been associated with duplicative and excessive fees and investor confusion.

At the same time, the rule proposal would impose costs on funds that could be required to change their portfolio to ensure compliance with the rule proposal. In particular, multi-tier structures that were formed in reliance on section 12(d)(1)(G) and on exemptive orders would need to be restructured. Funds relying on section 12(d)(1)(G) would be required to reallocate their investments to acquired funds that do not invest in underlying funds beyond the limits of section 12(d)(1) in reliance on an exemptive order. Alternatively, acquiring funds relying on section 12(d)(1)(G) could invest in the same acquired funds, but those acquired funds would incur costs to reduce their investments in other funds to comply with the limits of section 12(d)(1) of the Act.[315]

As of June 2018, there were 2,033 multi-tier structures. Some of these structures are within the statutory limits or are in compliance with the exceptions to the complex structures conditions contained in the proposed rule, and thus would not be affected by the proposed rule and the rescission of the exemptive orders. The remaining multi-tier structures would be required to modify their investments to ensure compliance with proposed rule 12d1–4 and the rescission of the exemptive orders. As of June 2018, there were: (i) 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); and (ii) no three-tier structures for which the first-tier fund relies on 12(d)(1)(G) to invest in the middle-tier fund and the middle-tier fund relies on exemptive orders to invest in the bottom-tier fund beyond the limits of section 12(d)(1).

Proposed rule 12d1–4 would prohibit an investment company that is relying on section 12(d)(1)(G) of the Act or proposed rule 12d1–4 from acquiring, in excess of the limits of section 12(d)(1)(A) of the Act, the outstanding voting securities of a fund that discloses in its most recent registration statement that it may be an acquiring fund in reliance on rule 12d1–4.[316] We estimate that complying with this disclosure requirement would impose a one-time

[309] This estimate is based on the following calculation: ($11,005 initial internal burden per UIT + $2,400 initial external burden per UIT) × 969 acquiring UITs = $12,989,445. *See* also *infra* footnotes 373 and 376.

[310] This estimate is based on the following calculation: $388 ongoing annual recordkeeping cost per UIT × 969 acquiring UITs = $375,972. *See* also *infra* footnote 375. In contrast to management companies, UITs do not charge management fees, but they charge sales charges. To the extent that the proposed rule would increase operating costs for UITs, UITs could pass through to investors any such cost increases in the form of higher sales charges.

[311] This estimate is based on the following calculation: $310 initial burden per separate account × 663 acquiring separate accounts = $205,530. *See also infra* footnote 380.

[312] This estimate is based on the following calculation: $78 ongoing annual burden per separate account × 663 acquiring separate accounts = $51,714. *See also infra* footnote 380.

[313] Proposed rule 12d1–4 wound permit an acquired fund to invest in other funds beyond the statutory limits (i) for short-term cash management purposes; (ii) in connection with inter-fund lending or borrowing transactions; (iii) in connection with master-feeder structures or investments in wholly-owned subsidiaries; or (iv) as a result of receiving fund shares as a dividend distribution or as a result of a plan reorganization.

[314] *See* proposed rule 12d1–4(b)(4)(i) and (ii). Proposed rule 12d1–4 would, however, permit an acquiring fund to be an acquired fund in connection with master-feeder arrangements and interfund borrowing and lending transactions.

[315] *See supra* section VI.C.1.a. for a detailed discussion of the costs of portfolio changes.

[316] *See* proposed rule 12d1–4(b)(4).

aggregate cost equal to $30,706,624 and an ongoing annual aggregate cost of $13,612,170.[317] Acquiring funds also would incur annual ongoing costs to review the disclosures of potential acquired funds equal to $553 per fund resulting in an aggregate annual ongoing cost of $2,401,126.[318] Lastly, funds that are acquired by 12(d)(1)(G) funds and currently rely on exemptive orders to invest in other funds beyond the limits of section 12(d)(1) would need to implement policies and procedures to monitor their investments in other funds beyond the limits of section 12(d)(1). We believe that any such additional costs are likely minimal because acquired funds already have policies and procedures to monitor their investments in other funds for compliance with the terms of the exemptive orders that could be leveraged to monitor compliance with the limits of the proposed rule.

Finally, as discussed in detail in section VI.C.1.c. above, the proposed restrictions on multi-tier structures would affect both current and prospective funds by restricting their investment flexibility. Proposed rule 12d1–4 would restrict funds' investment flexibility because: (i) It would limit funds' ability to acquire shares of acquiring funds beyond the limits of section 12(d)(1) and (ii) it would prohibit funds acquired by 12(d)(1)(G) funds from relying on exemptive orders to invest in other funds beyond the limits of section 12(d)(1).

We request comment on the impact of the complex structures conditions of proposed rule 12d1–4 on funds that would be required to modify their investments to comply with the condition. Please provide any available data or estimates in responding to these requests for comment.

• Would acquiring funds or acquired funds be required to change their portfolios to ensure compliance with the proposed complex structures conditions in the proposed rule? Would the complex structures conditions and the rescission of exemptive orders impose transaction costs on these funds?

• Would the complex structures conditions and the rescission of exemptive orders require funds to sell listed fund shares at potentially depressed prices? Would the fact that funds would be granted one year to bring their operations in compliance with the proposed rule mitigate any negative effects associated with the complex structures conditions?

• Would the complex structures conditions and the rescission of exemptive orders disrupt acquiring or acquired funds' investment strategies? In which ways?

• Would the complex structures conditions and the rescission of exemptive orders impose liquidity demands on acquired funds as a result of any potential fund redemptions?

• Would the complex structures conditions and the rescission of exemptive orders have tax implications for funds? If yes, in which ways?

• Are there any economic effects of the complex structure conditions that we have not identified? To the extent possible, please quantify any economic effects the economic analysis does not account for.

d. Assessment of Rule Proposal

Finally, existing acquired and acquiring funds relying on exemptive orders on which proposed rule 12d1–4 is based would incur a one-time administrative cost to assess whether their operations are consistent with the rule proposal. Further, existing acquiring funds would be required to decide whether to continue to rely on section 12(d)(1)(G) and amended rule 12d1–1 or instead rely on proposed rule 12d1–4 and comply with the associated conditions. We preliminarily believe this assessment would result in an aggregate cost of $22,750,845.[319]

2. Effects on Efficiency, Competition, and Capital Formation

a. Efficiency

Efficiency of current and prospective acquiring funds' asset allocation. The impact of the rule proposal on the efficiency of current and prospective acquiring funds' asset allocation is unclear ex-ante. On one hand, the rule proposal could promote the efficiency of funds' asset allocation. First, the proposed rule would eliminate the need for funds to apply for an exemptive order to structure certain funds of funds, and thus would eliminate the costs associated with the exemptive order process.[320] By eliminating the costs associated with the exemptive order process, the proposed rule would reduce frictions in funds' asset allocation and thus could promote the efficient allocation of funds' assets.

Second, the rule proposal would create a more consistent and efficient regulatory framework for funds of funds than the existing regulatory framework for the following reasons. First, proposed rule 12d1–4 would create a consistent framework for all registered funds and BDCs by providing 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 rule proposal would eliminate the existing overlapping and potentially inconsistent conditions for funds of funds and harmonize conditions across different fund arrangements. Regulatory consistency and efficiency could remove obstacles to funds' investments and operations because regulatory consistency and efficiency would decrease compliance and operating costs. By reducing compliance and operating costs, the rule proposal would further reduce frictions in asset allocation and could promote the efficient allocation of funds' assets.

Third, assuming that the proposed rule would increase funds' investment flexibility, it could increase the efficiency of funds' asset allocation because funds would be better able to diversify their investment portfolio. The proposed rule could increase funds' investment flexibility by expanding the scope of permissible acquiring and

[317] These estimates are based on the following calculations: $30,706,624 = 4,342 acquiring funds × ($1,602 one-time internal cost + $5,470 one-time external cost); $13,612,170 = 4,342 acquiring funds × ($400 ongoing annual internal cost + $2,735 ongoing annual external cost). *See infra* footnotes 341, 342, and 343.

[318] These estimates are based on the following calculations: 2 hours × $276.5 blended hourly rate for senior portfolio manager ($324) and intermediate portfolio manager ($229) = $553. $2,401,126 = 4,342 acquiring funds × $553 ongoing annual burden per acquiring fund. *See supra* footnote 287 for the source of salary data.

[319] We estimate that assessing the requirements of the proposed rule would 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 × $304 + 5 × $359) per fund. The total cost for the 6,863 acquiring and acquired funds that would rely on the proposed rule would thus be $22,750,845 (6,863 × $3,315). *See supra* footnote 287 for the source of salary data.

[320] The new and omitted conditions of proposed rule 12d1–4 would also affect the cost of operations of funds of funds. *See* section VI.C.1.c for a detailed discussion of the costs and benefits of the new and omitted conditions. 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 would be to increase (decrease) the cost of operations for funds of funds, the new and omitted conditions (i) could result in higher (lower) fees and expenses for fund investors and (ii) could decrease (increase) the number of available funds of funds, which would ultimately harm (improve) the efficient allocation of the assets of the acquiring fund investors.

acquired funds relative to the current exemptive orders. Fourth, the limit on fund redemptions under proposed rule 12d1–4 would incentivize acquiring funds to hold smaller percentages of the acquired fund shares to mitigate any negative effects of the limits on fund redemptions, which could ultimately result in a more diversified fund portfolio.

On the other hand, the rule proposal could reduce the efficiency of funds' asset allocation for two reasons. First, proposed rule 12d1–4 could affect funds' investment objectives due to the differential effects of the redemption limit on listed versus unlisted acquired funds and large versus small acquired funds, which ultimately could harm the efficient allocation of funds' assets. Second, assuming that the rule proposal would reduce funds' investment flexibility by prohibiting certain currently permissible funds of funds, it could decrease the efficiency of funds' asset allocation because funds would be less able to diversify their investment portfolio.

Efficiency of the asset allocation of current and prospective acquiring fund investors. The impact of the rule proposal on the efficiency of the asset allocation of current and prospective acquiring fund investors is unclear ex-ante. On one hand, the rule proposal could promote the efficiency of investors' asset allocation. First, proposed rule 12d1–4 would 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,[321] fund advisers/sponsors could pass through to investors the cost savings associated with eliminating the need to apply for an exemptive order, which could result in lower fees and expenses for acquiring fund investors.[322] Lower fees and expenses, in turn, could translate into improved efficiency of investors' asset allocation because investors could achieve the same investment objectives at a potentially lower cost. Similarly, the rule proposal would create a more consistent and more efficient regulatory framework. Fund advisers/sponsors could also pass through to investors any cost savings associated with a more consistent and efficient regulatory framework, which could result in lower fees and expenses, and more efficient allocation of acquiring fund investors' assets. Second, assuming that proposed rule 12d1–4 would increase funds' investment flexibility, the proposed rule would increase the diversity of available funds of funds, which could promote the efficient allocation of acquiring fund investors' assets because investors would be better able to diversity their investment portfolio.

On the other hand, the rule proposal could reduce the efficiency of investors' asset allocation. In particular, proposed rule 12d1–4 could decrease the diversity of available funds of funds because (i) it could reduce acquiring funds' investment flexibility and (ii) it could affect funds' investment objectives due to the differential effects of the redemption limit on listed versus unlisted acquired funds and large versus small acquired funds, which could decrease acquiring fund incentives to invest in small and unlisted acquired funds. A decrease in the diversity of available funds of funds would harm the efficient allocation of investors' assets because investors would be less able to diversify their investment portfolio.

Efficiency of prices of acquired funds and their underlying assets. The impact of the rule proposal on the efficiency of prices is unclear ex-ante. On one hand, the rule proposal could harm the efficiency of prices of the underlying assets of acquired funds because, as described above, the redemption limit could slow down the incorporation of negative information about the underlying assets of the acquired funds. On the other hand, the rule proposal could have a positive impact on the efficiency of the prices of acquired funds and their underlying assets. Proposed rule 12d1–4 could (i) increase the diversity of funds of funds by increasing funds' investment flexibility;[323] (ii) increase the number of available funds of funds by eliminating the need to apply for an exemptive order, by creating a more consistent and more efficient regulatory framework, and by reducing the cost of setting up a fund of funds; and (iii) enhance investor protection against undue influence, duplicative and excessive fees, and complex structures. The potential increase in the diversity and number of funds of funds and the enhancement of investor protection could increase the attractiveness of funds of funds, and thus could increase investors' demand for funds of funds. The increased investor demand for funds of funds could 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 could increase trading interest for those assets. Higher trading interest could lead to higher liquidity, lower trading costs, improved information production, and thus more efficient prices for those assets.[324]

In addition, the rule proposal could increase the price efficiency of listed acquired funds (*i.e.,* ETFs, ETMFs, listed closed-end funds, and listed BDCs) because investors could increase their investments in those funds through investments in funds of funds rather than investing directly in those funds. Consequently, the funds' investor base could shift from individual investors to acquiring funds. The investment advisers of acquiring funds are arguably more sophisticated than individual investors. A shift of certain funds' investor base to more sophisticated investors could in turn result in more efficient prices for listed acquired funds, because noise trading would decrease.[325]

b. Competition

The impact of the rule proposal on fund competition is unclear ex-ante. On one hand, the rule proposal could promote competition in the fund industry for the following reasons. First, to the extent that proposed rule 12d1–4 would increase acquiring funds' investment flexibility, the proposed rule could promote competition in the fund industry because it would increase the diversity of available funds of funds.[326] Second, the rule proposal would level the playing field for funds by expanding the scope of permissible acquiring and

[321] *See supra* footnotes 270 and 271.

[322] Any effects of eliminating the need to apply for an exemptive order are limited by the fact that each exemptive order can be used by multiple funds within the same fund complex and the costs of the exemptive order application process are one-time costs.

[323] As discussed in section VI.C.1.a above, the net effect of the proposed rule on funds' investment flexibility is unclear. To the extent that the proposed rule would decrease funds' investment flexibility, it could decrease the diversity of available funds of funds.

[324] *See, e.g.,* Anat R. Admati & Paul Pfleiderer, *A Theory of Intraday Patterns: Volume and Price Variability,* 1 Rev. of Fin. Stud., 3 (Spring 1988); Tarun Chordia, Richard Roll & Avanidhar Subrahmanyam, *Liquidity and Market Efficiency,* 87 J. of Fin. Econ., 249 (Feb. 2008).

[325] *See, e.g.,* Eli Bartov, Suresh Radhakrishnan, & Itzhak Krinsky, *Investor Sophistication and Patterns in Stock Returns after Earnings Announcements,* 75 The Acc. Rev., 43 (Jan. 2000); Joseph D. Piotroski & Darren T. Roulstone, *The Influence of Analysts, Institutional Investors, and Insiders on the Incorporation of Market, Industry, and Firm-Specific Information into Stock Prices,* 79 The Acc. Rev., 1119 (Oct. 2004); Ekkehart Boehmer & Eric K. Kelley, *Institutional Investors and the Informational Efficiency of Prices,* 22 Rev. of Fin. Stud., 3563 (Sept. 2009).

[326] 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. of Econ. Stud., 3 (Jan. 1982).

acquired funds and mandating the same conditions for similar funds of funds.[327] A more level playing field could increase competition in the fund industry because it would allow various funds to operate under similar conditions. Third, the rule proposal would contribute towards leveling the playing field for affiliated and unaffiliated acquired funds by imposing a limit on fund redemptions for both affiliated and unaffiliated acquired funds. Fourth, the rule proposal would create a more consistent and efficient regulatory framework than the current regulatory framework for funds of funds. To the extent that regulatory inefficiencies and inconsistencies could hamper funds' investment and growth, an increase in regulatory consistency and efficiency could result in the creation of more funds of funds, which could increase competition in the fund industry. Fifth, proposed rule 12d1–4 would remove the need to apply for an exemptive order and thus would decrease the cost of setting up a fund of funds. A decrease in the cost of setting up a fund of funds would lower the barriers to entry for new funds of funds, and thus could increase competition in the fund industry.

On the other hand, to the extent that the rule proposal would decrease funds' investment flexibility, it could harm competition among funds of funds because it would decrease the diversity of available funds of funds. In addition, proposed rule 12d1–4 would have a differential impact on publicly listed versus unlisted and large versus small funds, and this differential impact could harm competition in the fund industry. Specifically, the redemption limit under proposed rule 12d1–4 could provide an advantage to listed and large acquired funds because the redemption limit would be less binding for listed and large acquired funds. By providing a potential advantage to listed and large acquired funds and to the extent that there are economies of scale in fund operations, the proposed rule could have a negative effect on fund competition.

c. Capital Formation

The impact of the rule proposal on capital formation is unclear ex-ante. On one hand, the rule proposal could have a positive effect on capital formation. Specifically, the potential increase in fund investment flexibility, the potential leveling of the playing field as a result of the rule proposal, the increase in regulatory consistency and efficiency, and the decrease in the operating costs of prospective funds of funds as a result of removing the need to apply for an exemptive order could increase the number and diversity of funds of funds. An increase in the number and diversity of funds of funds could increase the demand for funds of funds, increase investor saving rates, increase investments in funds of funds, and ultimately increase demand for the funds of funds' underlying securities. Investor demand for funds of funds also could increase as a result of the new conditions of the proposed rule, which would enhance investor protection. As a result of the increased demand for the firms' equity and debt securities, companies would be able to issue new debt and equity at higher prices, which could lead to a decrease in the cost of capital of firms, and thus facilitate capital formation.[328] Nevertheless, we expect that any positive effects of the proposed rule on capital formation would be small.

On the other hand, assuming that single-tier funds and funds of funds are purely substitute investments, an increase in investors' demand for funds of funds could decrease the demand for single-tier fund structures. Consequently, under that assumption, there would be no change in the amount of money that flows to corporations and there would be no impact on capital formation as a result of the rule proposal.

D. Reasonable Alternatives

1. Retention of Existing Exemptive Relief

As discussed in section V above, we are proposing to rescind rule 12d1–2 and certain exemptive orders in connection with proposed rule 12d1–4 and amended rule 12d1–1. Alternatively, we could allow existing funds of funds to choose whether to operate under the existing regulatory framework or the new regulatory framework, and require only new funds of funds to comply with the new regulatory framework. The benefit of such an alternative would be that existing funds of funds would not incur the one-time switching costs from the existing regulatory framework to the new framework. 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 proposal's new requirements relating to redemption limits, multi-tier structures, and duplicative and excessive fees. Consequently, unlike the proposal, this alternative would establish a less uniform regulatory framework governing fund of funds arrangements.

2. Allow Private and Unregistered Investment Companies To Rely on Proposed Rule 12d1–4

As discussed above, proposed rule 12d1–4 is based in part on previously granted exemptive relief and would permit registered funds and BDCs to invest in registered funds and BDCs beyond the limits in section 12(d)(1). Alternatively, we could expand the scope of the proposed rule to allow private funds and unregistered investment companies to rely on the rule as acquiring funds. Expanding the proposed rule in this manner would increase investment flexibility for those funds, would level the playing field for those funds, and would broaden the funding opportunities for acquired funds because private funds and unregistered investment companies could increase their investments in them.

Nevertheless, we preliminarily believe that there are risks associated with expanding proposed 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 the proposed acquiring funds.[329] Second, private funds and unregistered investment companies are not subject to recordkeeping requirements under the Investment Company Act, and therefore, may not maintain the same records as a registered investment company. Third, unregistered foreign funds' investments in U.S. registered funds have raised concerns of abuse and undue influence in the past, which gave raise to

[327] 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 rule proposal would level the playing field for funds because it would 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 would be limited by the fact that different funds face different levels of restrictions on their investments that are unrelated to proposed rule 12d1–4 (*see, e.g., supra* footnote 37 for restrictions on BDC investments).

[328] 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. of Fin., 1325 (Sept. 1991).

[329] *See supra* footnote 47.

Congress's amendments to section 12(d)(1) in 1970.

3. Codify Current Conditions in Existing Exemptive Orders

As discussed above, proposed rule 12d1–4 would omit certain conditions contained in current exemptive orders that we believe are no longer necessary to prevent the abuses that section 12(d)(1) seeks to curtail in light of the new conditions being proposed. Proposed rule 12d1–4 also would include new conditions to address the potential for undue influence, complex structures, or duplicative and excessive fees. Alternatively, we could codify the conditions contained in existing exemptive orders rather than replacing certain conditions with alternative conditions as contained in the proposal.

This alternative approach would not impose the costs associated with the new conditions in the proposed rule, 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 proposed rule because of cross-sectional variation in the conditions of the exemptive orders. For example, this alternative would not limit an acquiring fund's ability to quickly redeem or tender a large volume of acquired fund shares to mitigate undue influence, which could impose liquidity constraints and restrict funds' investment flexibility. At the same time, this alternative would not result in cost savings associated with removing certain conditions that are no longer necessary in light of the new conditions, such as removing the need to enter into participation agreements. Nevertheless, we 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 no longer necessary in light of the new conditions of proposed rule 12d1–4.

4. 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 Proposed Control Limit

As discussed in section II.C.1 above, to address concerns about one fund exerting undue influence over another fund, proposed rule 12d1–4 is not available when an acquiring fund together with its advisory group controls the acquired fund. The proposed rule 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. The proposed rule includes an exception for funds that are in the same group of investment companies. The proposed rule 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. A lower limit could provide additional assurance that the proposed rule 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, management, or governance.[330] However, we expect that a lower limit could hamper the acquiring fund's ability to allocate its assets in an efficient and cost effective manner.[331]

We also could impose a lower limit while narrowing the scope of entities that would be assessed for the purposes of the ownership threshold. 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 have established already policies and procedures to monitor compliance with the aggregation requirement embedded in the proposed 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 would 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.[332]

Further, as an alternative, we could impose a limit lower than 25%, while imposing no limits on fund redemptions. The lower limit potentially would protect acquired funds from acquiring funds undue influence while allowing acquiring funds greater flexibility to liquidate their investments in acquired funds. As proposed, however, rule 12d1–4 balances these concerns by allowing acquiring funds to invest to a greater extent in acquired funds, subject to the proposed redemption limit.

Similarly, we could impose a limit higher than 25%, which would provide acquiring funds with greater investment flexibility. This alternative, however, would diverge from how control has been defined in the past under the Act. Moreover, 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 could influence the acquired fund for the benefit of the acquiring fund's shareholders, advisers, or sponsors. Lastly, given the proposed rule's 3% redemption limit, acquiring funds likely would not take advantage of a higher limit because it would take an acquiring fund longer to unwind a larger position in an acquired fund.

5. Alternative Approaches to the Redemption Limit

a. Do Not Impose Redemption Limit

As discussed above, proposed rule 12d1–4 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. The purpose of this prohibition is to address concerns that an acquiring fund could threaten large-scale redemptions to unduly influence an

[330] 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. Proposed rule 12d1–4 also contains a number of conditions aimed at protecting acquired funds from acquiring funds' undue influence.

[331] 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.

[332] For example, a family of target date funds tends to invest in different proportional allotments of the same underlying funds.

acquired fund. The proposed rule's 3% limit on fund redemptions in any 30-day period, however, could impose liquidity and investment flexibility constraints on current and prospective acquiring funds because acquiring funds would be unable to quickly liquidate their investments in funds if they hold more than 3% of the acquired fund's outstanding shares.

Alternatively, we could impose no limits on the redemptions of an acquired fund's shares. Instead, we could adopt conditions that generally require the acquired and acquiring fund boards to make certain findings and adopt procedures to prevent overreaching and undue influence by the acquiring fund and its affiliates once the acquired fund's investment exceeds the section 12(d)(1) limits, and also require the acquiring and acquired funds to enter into participation agreements. Similar, to section 12(d)(1)(F), we also could make rule 12d1–4's redemption provision permissive, by giving the acquired fund or its board the option to limit redemptions.

We believe that a redemption limit, together with the proposed control and voting conditions, are more protective of acquired funds because they provide protection against a broader set of circumstances than the targeted and prescriptive provisions in our exemptive orders. In addition, the redemption limit, together with the proposed control and voting conditions, may be more objectively tested as part of a fund's compliance program than the conditions currently found in our orders because they are based on numerical thresholds that are easily observable and verifiable.

b. Do Not Impose Redemption Limit for Funds Within the Same Group of Investment Companies

Proposed rule 12d1–4 imposes a redemption limit on all acquiring funds relying on the rule if they hold more than 3% of an acquired fund's outstanding voting securities. Alternatively, we could impose the redemption limit only on acquiring funds when: (i) The acquiring fund is not in the same group of investment companies as the acquired fund and (ii) the acquiring fund's investment sub-adviser is different from, and not in a control relationship with, the acquired fund's investment adviser or depositor. Such an approach would be similar to the exceptions to the control and voting conditions under proposed rule 12d1–4.

The benefit of such an alternative is that it would limit any costs associated with the redemption limit because any costs would be borne by only a subset of the acquiring funds.[333] In addition, such an alternative potentially would maintain investor protection because fund of funds arrangements involving control affiliates do not raise the same concerns regarding undue influence as other types of fund of funds arrangements. In circumstances where the acquiring fund and acquired fund share the same adviser or subadviser, the adviser or subadviser would owe a fiduciary duty to both funds, serving to protect the best interests of each fund. In addition, in cases where the arrangement involves funds that are advised by advisers that are control affiliates, the acquiring fund adviser is less likely to 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 acquiring fund through its ownership interest in the acquired fund.

Nevertheless, acquiring funds that fall within the exceptions in rule 12d1–4(b)(1)(iii) are not constrained in their ability to control a fund and could acquire more than 25% of an acquiring fund's outstanding voting securities. As a result, we propose to subject these types of acquiring funds to the redemption limitation in proposed rule 12d1–4(b)(2).

c. Impose Aggregate Redemption Limit on Acquiring Fund and Its Advisory Group

As discussed above, the proposed 3% redemption limit in proposed rule 12d1–4 only would apply to individual acquiring funds and thus would not apply to entities within an acquiring fund's advisory group.[334] Hence, the proposed redemption limit would provide limited protection to acquired funds when the shares of the acquired funds are held by multiple acquiring funds within the acquiring fund's advisory group.

Alternatively, we could impose a 3% or higher aggregate redemption limit applicable to an acquiring fund and its advisory group. To the extent that these entities could coordinate their redemptions to exercise undue influence on acquired funds through the threat of large scale redemptions, this proposed alternative would better protect acquired funds from acquiring funds' undue influence. Nevertheless, we believe that imposing a 3% aggregate redemption limit on an acquiring fund and its advisory group could significantly harm the liquidity and investment flexibility of acquiring funds, and could impose a higher monitoring burden on acquiring funds. Hence, we are not proposing to impose a 3% aggregate redemption limit on acquiring funds and their advisory group.

6. Permit Multi-Tier Fund Structures

As discussed above, proposed rule 12d1–4 would limit the creation of multi-tier structures. As an alternative, we could allow certain multi-tier fund structures by allowing funds to invest in an acquiring fund or by allowing acquired funds to invest in other funds beyond the limits in section 12(d)(1)(A). While this alternative would provide additional flexibility to funds to meet their investment objectives, it could potentially lead to duplicative and excessive fees and investor confusion.[335] In particular, the organizational complexity of multi-tier fund structures could make it difficult for acquired fund investors to understand who really controls the fund. Additionally, we believe that the proposed rule's exceptions to the multi-tier structures prohibition provide sufficient investment and funding flexibility to acquiring and acquired funds.

VII. Paperwork Reduction Act

A. Introduction

Proposed new rule 12d1–4 contains a ''collection of information'' within the meaning of the Paperwork Reduction Act of 1995 (''PRA'').[336] In addition, proposed rule 12d1–4 would affect the current collection of information burden of rule 0–2 under the Act.[337] The proposed amendments to Form N–CEN also would affect the collection of information burden under that form.[338]

The title for the new collection of information for rule 12d1–4 would be: ''Rule 12d1–4 Under the Investment Company Act of 1940, Fund of Funds Arrangements.'' The titles for the existing collections of information are: ''Rule 0–2 under the Investment

[333] Acquiring funds that invest in acquired funds beyond the limits of section 12(d)(1) when: (i) The acquiring fund is within 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 or depositor currently are not subject to redemption limits under section 12(d)(1)(G) and the exemptive orders.

[334] As discussed above, the control conditions in proposed rule 12d1–4 would apply to an acquiring fund's advisory group. *See supra* section II.C.1.

[335] Concerns of investor confusion are mitigated by fund disclosure requirements, such as prospectus and shareholder reports.

[336] 44 U.S.C. 3501 through 3521.

[337] 17 CFR 270.0–2.

[338] Form N–CEN [referenced in 17 CFR 274.101] under the Investment Company Act.

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 2008 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.[339] We received no comments on the collection of information requirements.

We discuss below the collection of information burdens associated with proposed rule 12d1–4 and its impact on rule 0–2, as well as proposed amendments to Form N–CEN.

B. Rule 12d1–4

Proposed rule 12d1–4 would 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 create a consistent and streamlined regulatory framework applicable to fund of funds arrangements while addressing investor protection concerns. The proposed rule would require an acquiring fund to disclose certain information in its registration statement, require an acquiring fund to follow certain procedures for voting an acquired fund's securities if certain ownership thresholds are met, require an acquiring fund's adviser (if the fund is a management company) or its principal underwriter or depositor (if the fund is a UIT) to make certain findings, require an acquiring fund (if the fund is a separate account funding a variable insurance contract) to obtain a certification from an insurance company issuing separate accounts, and require an acquiring fund to maintain certain records. These requirements are collections of information under the PRA.

The respondents to proposed rule 12d1–4 would be registered funds or BDCs. The collection of information would be mandatory only for entities that wish to rely on the new rule. Information provided to the Commission in connection with staff examinations or investigations would be kept confidential subject to the provisions of applicable law.

1. Disclosure Requirements

Under the proposed rule, a fund that relies on rule 12d1–4 (or intends to preserve flexibility to rely on rule 12d1–4) would be required to disclose in its registration statement that it is or may be an acquiring fund for purposes of rule 12d1–4.[340] The Commission staff estimates that complying with these disclosure requirements would impose a one-time internal hour burden of four hours, and an ongoing internal hour burden of one hour, on each acquiring fund to determine the disclosures appropriate to the fund and ensure that the appropriate disclosures are set forth in the fund's registration statement.[341] Additionally, the Commission staff estimates that these disclosure requirements would impose a one-time external cost burden of $5,470[342] and an ongoing external cost burden of $2,735 on each acquiring fund relating to board review and consultation with outside counsel.[343] Amortized over three years, the internal hour burden would be two hours per acquiring fund[344] and the annual external cost burden would be $3,647 per acquiring fund.[345]

2. Voting Provisions

Under proposed rule 12d1–4, where an acquiring fund and its advisory group (in the aggregate) hold more than 3% of the outstanding voting securities of an acquired fund, the acquiring fund would be required to vote those securities using either pass-through voting or mirror voting, unless the acquiring fund is covered by certain exceptions to the requirement.[346] This provision is designed to minimize the influence that an acquiring fund and its advisory group may exercise over an underlying fund through voting.

For purposes of this analysis, we estimate that approximately 809 funds would be acquiring funds holding more than 3% of the outstanding voting securities of an acquired fund, and would not fall within any of the proposed exceptions to the voting requirement, and thus would be subject to the voting requirement.[347] We further estimate that each of these acquiring funds invests in, on average, approximately 11 underlying funds.[348]

As discussed above, acquiring funds subject to the proposed voting condition would have the option of using either pass-through voting or mirror voting to vote their shares of the underlying fund. We estimate that approximately 98% of the funds that become subject to the voting condition would choose to implement mirror voting. Accordingly, we estimate that a total of approximately 793 acquiring funds, investing in a total of approximately 7,930 underlying funds, would use mirror voting. We further estimate that approximately 16 acquiring funds (2% of the 809 funds described above), investing in a total of approximately 160 underlying funds, would use pass-through voting. For this analysis, we estimate that each acquiring fund subject to the voting provision will participate in one vote on the securities of each acquired fund every three years.[349]

We estimate that all funds subject to the voting condition of proposed rule 12d1–4 would incur a one-time internal burden of 3 hours, monetized to $1,176 and amortized to $392 annually over 3 years, to update their proxy voting policies and related proxy voting

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[339] *See* 2008 Proposing Release, *supra* footnote 13.

[340] *See* proposed rule 12d1–4(b)(4).

[341] Monetized, the one-time four-hour internal burden translates to $1,602 and the ongoing one-hour internal burden translates to $400. These estimates are based on the following calculations: 4 hours × blended hourly rate of assistant general counsel (2 hours at $449/hour) and compliance attorney (2 hours at $352/hour) = $1,602; $400 = $1,602/4. *See supra* footnote 287 for the source of salary data.

[342] This estimate is based on the following calculation: 1 hour × $400 hourly rate of outside counsel + 1 hour × $5,070 hourly rate for board of directors = $5,470. *See supra* footnote 287 for the source of salary data.

[343] This estimate is based on the following calculation: 0.5 hour × $400 hourly rate of outside counsel + 0.5 hour × $5,070 hourly rate for board of directors = $2,735. *See supra* footnote 287 for the source of salary data.

[344] This estimate is based on the following calculation: (4 hours + 1 hour + 1 hour)/3 = 2 hours.

[345] This estimate is based on the following calculation: ($5,470 + $2,735 + $2,735)/3 = $3,647.

[346] *See* proposed rule 12d1–2(b)(1)(ii). As described above, in pass-through voting, the acquiring fund seeks voting instructions from its security holders and votes such proxies in accordance with their instructions. In mirror voting, the acquiring fund votes the shares it holds in the same proportion as the vote of all other holders.

[347] This estimate is based on data from the Morningstar Investment Company Holdings database.

[348] *Id.* This estimate of the average number of acquired funds per acquiring fund is based on the investments of the 4,342 acquiring funds summarized in Table 1, *supra* section VI.B.1. For purposes of this analysis, we assume that all existing acquiring funds would rely on proposed rule 12d1–4.

[349] This estimate takes into account the different voting frequencies of the types of acquired funds included in these calculations. For example, closed-end funds typically hold one vote per year, while mutual funds typically seek shareholder votes less frequently.

disclosures to reflect that the fund is subject to the voting procedures required under the rule.[350] In the aggregate, we estimate that funds subject to the proposed voting provision would incur a one-time internal burden of 2,427 hours, at a monetized value of $951,384.[351] Amortized over three years, the estimated burdens are one hour per fund, at a monetized value of $1,951.33. In the aggregate, amortized over three years, these estimated burdens equate to 809 hours and $951,384.[352] We further estimate that all funds subject to the voting condition of proposed rule 12d1–4 would incur a one-time external cost of $5,070 associated with the condition, or $1,690 amortized over 3 years.[353]

We estimate that each instance of mirror voting under the proposed voting condition would impose an annual internal burden of 3 hours on the acquiring fund to evaluate the votes of the other acquired fund's shareholders and submit its own votes, at a monetized internal cost of $1,176.[354] We further estimate that each instance of pass-through voting would impose an internal burden of 30 hours, which would include identifying the shareholders of record and their holdings, providing proxy statements to and otherwise communicating with those shareholders regarding the vote, compiling shareholder responses, and voting accordingly, at a monetized internal cost of $11,760.[355]

We estimate that compliance with the proposed voting condition also would impose external costs. For each instance of mirror voting, we estimate a cost of $400.[356] For each instance of pass-through voting, we estimate 10 hours of outside professional time, at a cost of $4,000.[357]

Accordingly, each year after the adoption of the proposed rule, in the aggregate, mirror voting by acquiring funds subject to the voting condition would impose an estimated internal annual burden of 8,564.4 hours with an external cost of $1,141,920.[358] Pass-through voting by acquiring funds would impose an estimated annual burden of 1,932 hours with an external cost of $230,400.[359] In the aggregate, the voting provision of proposed rule 12d1–4 therefore would impose an estimated internal annual burden of 10,292.4 hours with an external cost of $1,372,320.[360]

3. Management Companies—Adviser Evaluations and Board Oversight

In addition, in cases where the acquiring fund is a management company, proposed rule 12d1–4 would require the acquiring fund's adviser to evaluate the complexity of the structure and aggregate fees associated with the acquiring fund's investment in acquired funds, and find that it is in the best interest of the acquiring fund to invest in the acquired fund.[361]

Further, in cases where the acquiring fund is a management company, the proposed rule requires the acquiring fund's adviser to report to the acquiring fund's board of directors its finding that it is in the best interest of the acquiring fund to invest in the acquired fund and the basis for that finding.[362] The proposed rule requires this reporting before investing in acquired funds in reliance on the rule, and with such frequency as the board of directors of the acquiring fund deems reasonable and appropriate thereafter, but in any case, no less frequently than annually.[363]

Finally, an acquiring fund that is a management company would be required to maintain and preserve for a period of not less than five years, the first two years in an easily accessible place: (i) A written record of the adviser's finding that it is in the best interest of the acquiring fund to invest in the acquired funds; (ii) the basis for such finding; and (iii) any related reports provided by the adviser to the board of directors.[364]

These evaluations would impose both initial and ongoing burdens on management companies, related to both the evaluations themselves and the creation, review and maintenance of the aforementioned written materials associated with the evaluations. The Commission staff estimates the evaluations would impose an initial internal burden of 30 hours per fund.[365] Amortized over three years, this initial burden would equate to 10 hours per fund.[366] Because the rule requires ongoing evaluations with such frequency as the board of directors of the acquiring fund deems reasonable and appropriate, but in any case, no less frequently than annually, the Commission staff estimates that the evaluations (including the creation, review and maintenance of written materials associated with the evaluations) would impose an ongoing internal burden of 16 hours per fund.[367] Additionally, the staff estimates that these evaluations would impose an initial external cost of $17,610 [368] and external annual ongoing costs of

[350] *See, e.g.,* 17 CFR 270.30b1–4 (rule 30b1–4 under the Act). This estimate of the one-time annual hour burden consists of 3 hours × $392 hourly rate for an in-house attorney. *See supra* footnote 287 for the source of salary data. 3 × $392 = $1,176 per fund. We do not believe that funds subject to the proposed voting provision would incur any ongoing time or cost burdens associated with proxy voting policies and procedures or related disclosures.

[351] These estimates are based on the following calculations: 809 acquiring funds × 3 hours = 2,427 hours; 809 acquiring funds × $1,176 = $951,384.

[352] These estimates are based on the following calculations: 2,427 hours/3 = 809 hours; $951,384/3 = $317,128.

[353] These estimates are based on the following calculations: 1 hour × $5,070 hourly rate for board of directors = $5070; 5,070/3 = $1,690. *See supra* footnote 287 for the source of salary data.

[354] This estimate is based on the following calculations: 3 hours × $392 hourly rate for in-house attorney = $1,176. *See supra* footnote 287 for the source of salary data.

[355] This estimate is based on the following calculations: 30 hours × $392 hourly rate for in-house attorney = $11,760. See *supra* footnote 287 for further explanation of salary data.

[356] This estimate is based on the following calculations: 1 hour × hourly rate for outside counsel of $400 = $400. *See supra* footnote 287 for further explanation of salary data.

[357] This estimate is based on the following calculations: 10 hours × hourly rate for outside counsel of $400 = $4,000. *See supra* footnote 287 for further explanation of salary data.

[358] These estimates are based on the following calculations: 793 acquiring funds × 3.6 mirror votes per year × 3 hours per mirror vote = 8,564.4 hours; 793 acquiring funds × 3.6 mirror votes per year × $400 per mirror vote = $1,141,920. (3.6 mirror votes per year = 11 (average number of acquired funds in which each acquiring fund invests)/3 years.) *See supra* footnote 348.

[359] These estimates are based on the following calculations: 16 acquiring funds × 3.6 pass-through votes per year × 30 hours per pass-through vote = 1,728 hours; 16 acquiring funds × 3.6 pass-through votes per year × $4,000 per pass-through vote = $230,400. (3.6 pass-through votes per year = 11 (average number of acquired funds in which each acquiring fund invests)/3 years.) *See supra* footnote 348.

[360] These estimates are based on the following calculations: 8,564.4 hours + 1,728 hours = 10,292.4 hours; $1,141,920 + $230,400 = $1,372,320.

[361] Proposed rule 12d1–4(b)(3)(i).

[362] *Id.*

[363] *Id.*

[364] Proposed rule 12d1–4(c).

[365] These burden hours translate to a monetized cost of $11,005 per fund. This estimate is based on the following calculation: 15 hours × $352 hourly rate for compliance attorney + 10 hours × $317 hourly rate for senior portfolio manager + 5 hours × $511 hourly rate for chief compliance officer = $11,005. *See supra* footnote 287 for the source of salary data. Amortized over three years, the monetized annual cost of the initial hour burden would be $3,590. This estimate is based on the following calculation: $11,005/3 = $3,669.

[366] This estimate is based on the following calculation: 30 hours/3 years = 10 hours per year.

[367] These 16 burden hours translate to a monetized annual cost of $2,887 per fund. This estimate is based on the following calculations: 6 hours × $352 hourly rate for compliance attorney = $2,112; 5 hours × $61 hourly rate for general clerk = $305; 5 hours × $94 hourly rate for senior computer operator = $470. See supra footnote 287 for the source of salary data.

[368] This estimate is based on the following calculation: 3 hours × $5,070 hourly rate for board of directors + 6 hours × $400 hourly rate for outside counsel = $17,610. *See supra* footnote 287 for the source of salary data.

$5,870 [369] per fund on management companies, relating to the need for board review and consultation with outside counsel.

4. UITs—Principal Underwriter or Depositor Evaluations

The proposed rule would also require that, in cases where the acquiring fund is a registered UIT, the UIT's principal underwriter or depositor must evaluate the complexity of the structure and the aggregate fees associated with the UIT's investment in acquired funds, and find that the UIT's fees do not duplicate the fees of the acquired funds that the UIT holds or will hold at the date of deposit.[370] This evaluation must take place on or before of the date of initial deposit of portfolio securities into the UIT.[371]

An acquiring fund that is a UIT also would be required to maintain and preserve for a period of not less than five years, the first two years in an easily accessible place, the UIT's principal underwriter or depositor's finding that the UIT's fees do not duplicate the fees of the acquired funds and the basis for such finding.[372]

These evaluations would impose both initial and ongoing burdens on UITs, related to both the evaluations themselves and the creation, review and maintenance of the aforementioned written materials associated with the evaluations. The Commission staff estimates the evaluations would impose an initial internal burden of 30 hours per fund.[373] Amortized over three years, this initial burden would equate to 10 hours per fund.[374] Because the rule requires ongoing maintenance of written materials, the Commission staff estimates that the evaluations would impose an ongoing burden of five hours per fund, due to recordkeeping obligations related to the evaluations.[375] The Commission staff further estimates that these evaluations would impose an initial external cost of $2,400 for consultation with outside counsel.[376] In contrast to the external annual ongoing costs noted above for management companies, the Commission staff estimates that these evaluations would impose no external annual ongoing costs on UITs, because the rule would only require each UIT to make a single determination on or before of the date of initial deposit of portfolio securities into the UIT.[377]

5. Separate Accounts Funding Variable Insurance Contracts—Certificates

Additionally, the proposed rule would 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 that the insurance company has determined that the fees 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)).[378] The acquiring fund would also be subject to the proposed rule's recordkeeping provisions.[379] An insurance company already is required to make these fee-related determinations, but obtaining the aforementioned certifications and maintaining the certifications for recordkeeping purposes would impose new burdens on the acquiring fund.

The Commission staff estimates that obtaining these certifications and maintaining them for recordkeeping purposes would impose a one-time internal hour burden of four hours, then an ongoing internal hour burden of one hour, on each acquiring fund. Amortized over three years, the internal hour burden would be two hours per acquiring fund.[380] The staff estimates that obtaining and maintaining the certifications would not require board review or consultation with outside counsel, and would therefore impose no additional external costs on these acquiring funds.

C. Rule 0–2

Section 6(c) of the Act provides the Commission with authority to conditionally or unconditionally exempt persons, securities or transactions from any provision of the Act if and to the extent that 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. Rule 0–2 under the Act, entitled ''General Requirements of Papers and Applications,'' prescribes general instructions for filing an application seeking exemptive relief with the Commission.[381] We currently estimate for rule 0–2 a total hour burden of 5,340 hours at an annual time cost of $2,029,200.60 and the total annual external cost burden is $14,090,000.[382]

Proposed rule 12d1–4 would permit acquiring funds to invest in acquired funds beyond the limits in section 12(d)(1) of the Act subject to several conditions that are designed to limit the acquiring funds' control over the acquired funds, limit the potential for duplicative or excessive fees, and limit the construction of complex structures that may confuse investors. Many of these fund of funds arrangements are permitted under current Commission exemptive orders. Therefore, proposed rule 12d1–4 would alleviate some of the burdens associated with rule 0–2 because it would reduce the number of entities that require exemptive relief in order to operate. The Commission staff estimates that this reduction would decrease the annual aggregate burden by approximately $5,400,000 (approximately 33.5%).[383] Therefore, in the aggregate, we estimate that proposed rule 12d1–4 would result in a decrease of the annual burden of rule 0–2 to approximately 3,551 [384] hours at an

[369] This estimate is based on the following calculation: 1 hour × $5,070 hourly rate for board of directors + 2 hours × $400 hourly rate for outside counsel = $5,870. *See supra* footnote 287 for the source of salary data.

[370] Proposed rule 12d1–4(b)(3)(ii).

[371] *Id.*

[372] Proposed rule 12d1–4(c).

[373] These burden hours translate to a monetized cost of $11,005 per fund. This estimate is based on the following calculation: 15 hours × $352 hourly rate for compliance attorney + 10 hours × $317 hourly rate for senior portfolio manager + 5 hours × $511 hourly rate for chief compliance officer = $11,005. *See supra* footnote 287 for the source of salary data. Amortized over three years, the monetized annual cost of the initial hour burden would be $3,590. This estimate is based on the following calculation: $11,005/3 = $3,669.

[374] This estimate is based on the following calculation: 30 hours/3 years = 10 hours per year.

[375] These five burden hours translate to a monetized annual cost of $388 per fund. This estimate is based on the following calculation: 2.5 hours × $61 hourly rate for general clerk + 2.5 hours × $94 hourly rate for senior computer operator = $388. *See supra* footnote 287 for the source of salary data.

[376] This estimate is based on the following calculation: 6 hours × $400 hourly rate for outside counsel = $2,400. Amortized over three years, this initial cost is equal to $800 (based on a calculation of $2,400/3). *See supra* footnote 287 for the source of salary data.

[377] Proposed rule 12d1–4(b)(3)(ii).

[378] Proposed rule 12d1–4(b)(3)(iii).

[379] Proposed rule 12d1–4(c).

[380] This estimate is based on the following calculation: (4 hours + 1 hour + 1 hour)/3 = 2 hours. These two burden hours translate to a monetized annual cost of $155 per fund. This estimate is based on the following calculation: 1 hour × $61 hourly rate for general clerk + 1 hour × $94 hourly rate for senior computer operator = $155. *See supra* footnote 287 for the source of salary data.

[381] *See* Supporting Statement of Rule 0–2 under the Investment Company Act of 1940, General Requirements of Paper Applications (Nov. 23, 2016) (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=201602-3235-008.*

[382] This estimate is based on the last time the rule's information collection was submitted for PRA renewal in 2016.

[383] *See supra* footnote 267 and accompanying text. $5,400,000/($2,029,200.60 + $14,090,000) = 0.335.

[384] This estimate is based on the following calculation: 5,340 hours − (5,340 hours × 0.335) = 3,551 hours.

annual time cost of $1,349,418 [385] and an annual external cost of $9,369,850.[386]

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.[387] Today, the Commission is proposing an amendment to 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.[388]

In the Reporting Modernization Adopting Release, we estimated that the Commission would receive an average of 3,113 reports on Form N–CEN.[389] We estimated that the average annual hour burden per response for Form N–CEN for the first year to be 32.37 hours and 12.37 hours in subsequent years.[390] Amortizing the burden over three years, we estimated the average annual hour burden per fund per year to be 19.04 hours and the total aggregate annual hour burden to be 59,272 hours.[391] Finally, we estimated that all applicable funds will incur, in the aggregate, external annual costs of $2,088,176 to prepare and file reports on Form N–CEN.[392]

Based on Commission staff experience, we believe that our proposal to require management companies and UITs to report whether they relied on section12(d)(1)(G) or rule 12d1–4 during the reporting period would increase the estimated burden hours associated with Form N–CEN by approximately 0.1 hours,[393] both initially and on an ongoing basis.[394] Therefore, in the aggregate, we estimate that management companies and UITs will incur an annual burden of an additional 303.8 hours, to comply with the proposed amendments to Form N–CEN.[395] We estimate that there are no additional external costs associated with this collection of information.

E. Request for Comments

We request comment on whether our estimates for burden hours and any external costs as described above are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (i) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) determine whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

The agency is submitting the proposed collections of information to OMB for approval. Persons wishing to submit comments on the collection of information requirements of the proposed rule should direct them to the Office of Management and Budget, Attention Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549–1090, with reference to File No. S7–27–18. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this release; therefore, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7–27–18, and be submitted to the Securities and Exchange Commission, Office of FOIA Services, 100 F Street NE, Washington, DC 20549–2736.

VIII. Initial Regulatory Flexibility Analysis

The Commission has prepared the following Initial Regulatory Flexibility Analysis (''IRFA'') in accordance with section 3(a) of the Regulatory Flexibility Act (''RFA'').[396] It relates to proposed rule 12d1–4 and the proposed amendments to Form N–CEN under the Investment Company Act.

A. Reasons for and Objectives of the Proposed Actions

Proposed rule 12d1–4 would 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 propose to rescind rule 12d1–2 under the Act and individual exemptive orders for certain fund of funds arrangements to create a consistent and efficient rules-based regime for the formation and oversight of funds of funds. We also propose to amend 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 proposed amendments to Form N–CEN would allow the Commission to better monitor funds' reliance on rule 12d1–4 and section 12(d)(1)(G), and would assist the Commission with its accounting, auditing, and oversight functions.

B. Legal Basis

The Commission is proposing 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 proposing amendments 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)].

[385] This estimate is based on the following calculation: $2,029,200.60 − ($2,029,200.60 × 0.335) = $1,349, 418.40.

[386] This estimate is based on the following calculation: $14,090,000 − ($14,090,000 × 0.335) = $9,369,850.

[387] *See* Reporting Modernization Adopting Release, *supra* footnote 48. The compliance date for Form N–CEN is June 1, 2018.

[388] Item C.7.a. of Form N–CEN currently requires funds to disclose if they are relying on rule 12d1–1. The Commission is proposing to add to Form N–CEN requirements that funds report if they are relying on section 12(d)(1)(G) or rule 12d1–4. *See* Proposed Items C.7.l. and m. of Form N–CEN (relating to management companies) and Proposed Items F.18 and F.19 (relating to UITs).

[389] *See* Reporting Modernization Adopting Release, *supra* footnote 48 at text accompanying n.1524.

[390] *See* Reporting Modernization Adopting Release, *supra* footnote 48 at text accompanying nn.1531–1532.

[391] *See* Reporting Modernization Adopting Release, *supra* footnote 48 at text accompanying nn.1533–1534.

[392] *See* Reporting Modernization Adopting Release, *supra* footnote 48 at text accompanying n.1538.

[393] This estimate stems from the Commission staff's understanding of the time it takes to complete initially complete and review items on Form N–CEN.

[394] We also have revised our estimate of the number of reports on Form N–CEN per year down from 3,113 reports to 3,038 reports to reflect updates to the industry data figures that were utilized in the Reporting Modernization Release. This estimate is based on the number of entities as of December 2017 that we expect will be required to make filings on Form N–CEN. *See* Reporting Modernization Adopting Release, *supra* footnote 48 at text accompanying n.1524.

[395] This estimate is based on the following calculation: 0.1 hours × 3,038 filers = 303.8 hours.

[396] 5 U.S.C. 603(a).

C. Small Entities Subject to the Proposed Requirements

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.[397] Commission staff estimates that, as of June 2018, there were 59 open-end funds (including 10 ETFs), 32 closed-end funds, 6 UITs, and 19 BDCs that would be considered small entities that may be subject to proposed rule 12d1–4.[398] For the purposes of this analysis, we estimate that, of those 116 total entities, 8 entities (3 open-end funds, 4 closed-end funds, and 1 UIT) invest in other funds and thus may be subject to the proposed rule.[399]

D. Projected Board Reporting, Recordkeeping, and Other Compliance Requirements

We are proposing new rule 12d1–4 to streamline and enhance the regulatory framework applicable to fund of funds arrangements, the rescission of rule 12d1–2 and individual exemptive orders for certain fund of funds arrangements in order to create a consistent and efficient rules-based regime for the formation and oversight of fund of funds, and 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.

A fund that relies on rule 12d1–4 (or intends to preserve flexibility to rely 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 rule 12d1–4. In addition, under proposed rule 12d1–4, where an acquiring fund and its advisory group (in the aggregate) hold more than 3% of the outstanding voting securities of an acquired fund, the acquiring fund would be required to vote those securities using either pass-through voting or mirror voting, unless the acquiring fund is covered by certain exceptions to the requirement. In cases where the acquiring fund is a management company, proposed rule 12d1–4 would require the acquiring fund's adviser to evaluate the complexity of the structure and aggregate fees associated with the acquiring fund's investment in acquired funds, and find that it is in the best interest of the acquiring fund to invest in the acquired funds. Proposed rule 12d1–4 also would require that, in cases where the acquiring fund is a registered UIT, the UIT's principal underwriter or depositor must evaluate the complexity of the structure and the aggregate fees associated with the UIT's investment in acquired funds, and find that the UIT's fees do not duplicate the fees of the acquired funds that the UIT holds or will hold at the date of deposit. Additionally, the proposed rule would 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 that the insurance company has determined that the fees 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.

To harmonize the overall regulatory structure in view of proposed rule 12d1–4, we are proposing to rescind existing exemptive orders (as discussed below) and 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. We also propose to amend 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 proposing an amendment to 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.

Proposed new rule 12d1–4, the rescission of rule 12d1–2, 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 proposed rule 12d1–4 would be 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 would be 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 proposed 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) Two internal burden hours and $3,647 in external costs to satisfy new disclosure requirements;[400] (b) 1 internal burden hour and $800 in external costs to satisfy the proposed voting requirement;[401] (c) for management companies, 26 internal burden hours and $11,740 in external costs to satisfy the proposed complex structure and aggregate fees analysis requirement,[402] and for UITs, 15 internal burden hours and $800 in external costs to satisfy the proposed complex structure and aggregate fees analysis.[403] Furthermore, as discussed above, we estimate that each entity that relies on the proposed new rule would incur an additional annual time burden of 0.1 hours to comply with the amendments to Form N–CEN.[404]

Therefore, in the aggregate, we estimate that small entities would incur an annual internal burden of 221 additional hours and an annual external cost burden of $118,556 to comply with the requirements of proposed rule 12d1–4.[405] Furthermore, in the aggregate, we estimate that small entities would incur an annual burden of an additional 0.8 hours to comply with the amendments to Form N–CEN.[406]

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[397] *See* rule 0–10(a) under the Investment Company Act.

[398] This estimate is derived an analysis of data obtained from Morningstar Direct as well as data reported to the Commission for the period ending June 30, 2018. There are currently no ETMFs or face-amount certificate companies that would be considered small entities. We estimate that no BDCs that are small entities invest in other funds.

[399] *Id.*

[400] *See supra* footnotes 340 through 345 and accompanying text.

[401] *See supra* footnotes 349 through 356 and accompanying text. We expect that small entities subject to the voting requirement would choose to use mirror voting rather than pass-through voting, and thus use our estimates for mirror voting here.

[402] *See supra* footnotes 365 through 369 and accompanying text.

[403] *See supra* footnotes 373 through 377 and accompanying text.

[404] *See supra* footnotes 393 through 394 and accompanying text.

[405] This estimate is based on the following calculations:

(2 internal burden hours and $3,647 in external costs) × 8 total small entities for disclosure requirements + (1 internal burden hour and $800 in external costs) × 8 total small entities for voting requirements + (26 internal burden hours and $11,740 in external costs) × 7 management company small entities for fee-related requirements + (15 internal burden hours and $800 in external costs) × 1 UIT small entity for fee-related requirements = 221 internal burden hours and $118,556.

[406] This estimate is based on the following calculations: 0.1 hours × 8 small entities = 0.8 hours.

In addition, the economic effects of proposed rule 12d1–4's redemption limit, discussed above in section VI.C.1.d, may disproportionately affect smaller entities by creating an incentive for acquiring funds to invest in larger acquired funds rather than smaller acquired funds. This may reduce the flow of capital to smaller potential acquired funds. 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. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission has not identified any federal rules that duplicate, overlap, or conflict with the proposed fund of funds regulations.

F. Significant Alternatives

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 proposed disclosure, findings, board reporting, and recordkeeping requirements: (i) Exempting small entities from some or all of the proposed requirements to rely on proposed 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 simplifying the compliance requirements under proposed rule 12d1–4 for small entities; and (iii) using performance rather than design standards.

We do not believe that exempting or establishing different requirements for any subset of funds, including funds that are small entities, from proposed rule 12d1–4 or the proposed amendments to rule 12d1–1 and Form N–CEN or the proposed rescission of rule 12d1–2 and certain existing exemptive relief would permit us to achieve our stated objectives.[407] Nor do we believe that clarifying, consolidating or simplifying the various aspects of the proposal 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, would benefit from the proposed rule and form amendments. We believe that our proposal 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 our proposed requirements are vital to that balance and important to all investors, irrespective of the size of the entity. We note that the current 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.

G. General Request for Comment

The Commission requests comments regarding this analysis. We request comment on the number of small entities that would be subject to the proposed rules and whether the proposed rules would have any effects on small entities that have not been discussed. We request that commenters describe the nature of any effects on small entities subject to the proposed rules and provide empirical data to support the nature and extent of such effects. We also request comment on the estimated compliance burdens of the proposed rules and how they would affect small entities.

IX. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or ''SBREFA,''[408] we must advise OMB whether a proposed regulation constitutes a ''major'' rule. Under SBREFA, a rule is considered ''major'' where, if adopted, it results in or is likely to result in: (1) An annual effect on the economy of $100 million or more; (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effects on competition, investment or innovation.

We request comment on the potential impact of the proposed rule and form amendments on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

X. Statutory Authority

The Commission is proposing 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 proposing 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 Proposed Rules and Form Amendments

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended 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.

* * * * *

§ 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:

[407] This includes exempting or establishing any different requirements relating to proposed rule 12d1–4's redemption limits. *See supra* section VI.C.1.d.

[408] Public Law 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

§ 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), and 57 of the Act (15 U.S.C. 80a–12(d)(1)(A), 80a–12(d)(1)(C), 80a–17(a) and 80a–56):

(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''); and

(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.

(b) *Conditions.*

(1) *Control.*

(i) The acquiring fund and its advisory group will not control (individually or in the aggregate) an acquired fund; and

(ii) If the acquiring fund and its advisory group, in the aggregate, hold more than 3% of the outstanding voting securities of an acquired fund, each of those holders will vote its securities in the manner prescribed by section 12(d)(1)(E)(iii)(aa) of the Act (15 U.S.C. 80a–12(d)(1)(E)(iii)(aa));

(iii) The conditions in paragraphs (b)(1)(i) and (ii) of this section do not apply when:

(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) *Limited redemption.* An acquiring fund that holds shares of an acquired fund in excess of the limits of section 12(d)(1)(A)(i) of the Act (15 U.S.C. 80a–12(d)(1)(A)(i)) does not redeem or submit for redemption, or tender for repurchase, any of those shares in an amount exceeding 3% of the acquired fund's total outstanding shares during any thirty-day period in which the acquiring fund holds the acquired fund's shares in excess of that limit.

(3) *Fees and other considerations.*

(i) *Management companies.* If the acquiring fund is a management company, before investing in an acquired fund in reliance on this section, and with such frequency as the acquiring fund's board of directors deems reasonable and appropriate thereafter, but in any case, no less frequently than annually, the acquiring fund's investment adviser must evaluate the complexity of the structure and aggregate fees associated with the acquiring fund's investment in the acquired fund, and find that it is in the best interest of the acquiring fund to invest in the acquired fund. The acquiring fund's investment adviser must report its finding and the basis for the finding to the acquiring fund's board of directors.

(ii) *Unit investment trusts.* If the acquiring fund is a unit investment trust and the date of initial deposit of portfolio securities into a registered UIT occurs after the effective date of this section, the UIT's principal underwriter or depositor must evaluate the complexity of the structure and the aggregate fees associated with the UIT's investment in acquired funds and, on or before such date of initial deposit, find that the UIT's fees do not duplicate the fees of the acquired funds that the UIT holds or will hold at the date of deposit.

(iii) *Separate account 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 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)).

(4) *Complex fund structures.*

(i) An investment company must disclose in its registration statement that it is (or at times may be) an acquiring fund for purposes of this section;

(ii) 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 another investment company that discloses in its most recent registration statement that it may be an acquiring fund under this section; and

(iii) An acquired fund must not acquire the securities of another investment company (or companies that would be investment companies 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)) in excess of the limits in section 12(d)(1)(A) of the Act (15 U.S.C. 80a–12(d)(1)(A)) unless the acquired fund's investment is:

(A) In reliance on section 12(d)(1)(E) of the Act (15 U.S.C. 80a–12(d)(1)(E));

(B) For short-term cash management purposes pursuant to § 270.12d1–1 or exemptive relief from the Commission;

(C) In a subsidiary that is wholly-owned and controlled by the acquired fund;

(D) The receipt of securities as a dividend or as a result of a plan of reorganization of a company; or

(E) The acquisition of securities of another investment company pursuant to exemptive relief from the Commission to engage in interfund borrowing and lending transactions.

(c) *Recordkeeping.* The acquiring fund must maintain and preserve for a period of not less than five years, the first two years in an easily accessible place, a written record of:

(1) The finding required by paragraph (b)(3)(i) of this section and the basis for such finding, and the reports provided to the board of directors pursuant to paragraph (b)(3)(i) of this section;

(2) The finding required by paragraph (b)(3)(ii) of this section and the basis for such finding; and

(3) The certification from each insurance company required by paragraph (b)(3)(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.

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.

*   *   *   *   *

PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

■ 5. The general authority citation for part 274 continues to read as follows, and the sectional authorities for §§ 274.101 and 274.130 are removed:

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 k. and l.; and

■ b. In Part F, adding Item F.18. and Item F.19.

Note: The text of Form N–CEN does not and the amendments will not appear in the Code of Federal Regulations.

The revisions and additions read as follows:

FORM N–CEN

ANNUAL REPORT FOR REGISTERED INVESTMENT COMPANIES

* * * * *

Part C. Additional Questions for Management Investment Companies

* * * * *

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)

* * * * *

k. Rule 12d1–4 (17 CFR 270.12d1–4): ___

l. Section 12(d)(1)(G) of the Act (15 U.S.C. 80a–12(d)(1)(G)): ___

* * * * *

Part F. Additional Questions for Unit Investment Trusts

* * * * *

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 U.S.C. 80a–12(d)(1)(G)) during the reporting period? [Y/N]

* * * * *

By the Commission.

Dated: December 19, 2018.

Brent J. Fields,

Secretary.

[FR Doc. 2018–27924 Filed 1–31–19; 8:45 am]

BILLING CODE 8011–01–P