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Investment Company Act of 1940 – Rule 12d1-2

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Dear Mr. Marchesani:

Prior to the adoption by the U.S. Securities and Exchange Commission (“Commission”) of Rule 12d1-2 under the Investment Company Act of 1940, as amended (the “1940 Act”), in 2006, registered open-end investment companies that relied on Section 12(d)(1)(G) (“open-end funds”)¹ could only invest in other **open-end** funds within the same “group of investment companies.” The SEC adopted Rule 12d1-2 to widely broaden the types of securities in which an open-end fund could invest, including securities issued by other investment companies. Accordingly, Rule 12d1-2 permitted an open-end fund to invest in other investment companies, including registered **closed-end** investment companies (“closed-end funds”),² as set forth in the Rule. There is no indication that the Commission intended to prevent an open-end fund from investing in **closed-end** funds that could be deemed to be within the same “group of investment companies” as the investing fund. However, the wording of Rule 12d1-2 arguably could be read to prevent these investments, which we believe would contradict the Commission’s intent.

Accordingly, we request that the staff of the Commission’s Division of Investment Management concur with our interpretation that the definition of “group of investment companies” as defined in Section 12(d)(1)(G)(ii) of the 1940 Act, refers solely, for the purposes of Rule 12d1-2(a)(1) under the 1940 Act, to **open-end** funds that hold themselves out to investors as related companies for purposes of investment and investor services. This interpretation would clarify that an open-end fund relying on Section 12(d)(1)(G) and Rule 12d1-2 would be permitted to invest, within the limits set forth in the Rule, in a **closed-end** fund regardless of whether the two funds belong to the same group of investment companies.

¹ For the purposes of this letter, the term open-end fund may also refer to registered unit investment trusts (“UITs”) that may rely on Section 12(d)(1)(G) of the 1940 Act and Rule 12d1-2 thereunder.

² For the purposes of this letter, the term closed-end fund may also refer to business development companies that, pursuant to Section 60 of the 1940 Act, are subject to Section 12(d)(1) of the 1940 Act.

I. LEGAL BACKGROUND ON SECTION 12(D)(1)(G) AND RULE 12D1-2

The 1940 Act restricts investment companies' ability to purchase the securities of other investment companies to "prevent fund of fund arrangements that have been used in the past to enable investors in an acquiring fund to control the assets of an acquired fund and use those assets to enrich themselves at the expense of acquired fund shareholders."³ Specifically, Section 12(d)(1) generally makes it unlawful for a registered investment company to purchase or otherwise acquire any security issued by another registered investment company except in accordance with the limits set forth in that Section. Section 12(d)(1) was enacted to prevent unregulated pyramiding of investment companies and the abuses that are perceived to arise from such pyramiding such as: (i) duplicative costs; (ii) the exercise of undue influence or control over the underlying funds; and (iii) the complexity of such arrangements.⁴

Section 12(d)(1)(A) prohibits a registered investment company ("acquiring fund") from acquiring the securities of any other registered investment company ("acquired fund") if, immediately after the acquisition: (a) the acquiring fund owns more than 3% of the total outstanding voting stock of the acquired fund; (b) the value of the securities of any acquired fund exceeds 5% of the total assets of the acquiring fund; or (c) the aggregate value of the securities of all investment companies owned by the acquiring fund exceeds 10% of its total assets. This investment limitation is often referred to as the "3/5/10 limits."⁵

Although Section 12(d)(1) had been quite effective in preventing abusive fund of funds arrangements, the broad nature of the prohibition also had the effect of preventing "legitimate fund of funds arrangements."⁶ To that end, Congress in 1996 enacted a set of exemptions to the 3/5/10 limits.⁷ One of these exemptions, Section 12(d)(1)(G), provides an exemption for fund of funds arrangements for open-end funds to invest in other open-end funds that are part of the same "group

³ See Fund of Funds Investments, 71 Fed. Reg. 36640 (Jun. 27, 2006) ("Fund of Funds Release").

⁴ See Public Policy Implications of Investment Company Growth, in H.R. Rep. No. 2337, at 311-24 (1966).

⁵ In addition to the 3/5/10 limits set forth in Section 12(d)(1)(A), Section 12(d)(1)(B) prohibits an open-end fund from selling its securities to an acquiring fund if immediately after the sale: the acquiring fund and companies controlled by the acquiring fund would own more than 3% of the voting stock of the acquired fund; or the acquiring fund, together with any other funds and companies controlled by them, own more than 10% of the total outstanding voting stock of the acquired fund. Section 12(d)(1)(C) limits an investment company and any companies controlled by it to acquire any security issued by a closed-end fund, if immediately after such acquisition, the investing fund, other funds having the same investment adviser, and companies controlled by such funds, own more than 10% of the total outstanding voting stock of the acquired closed-end fund.

⁶ Fund of Funds Release at 36640.

⁷ See National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 202, 110 Stat. 3416, 3427 (1996).

of investment companies,” together with Government securities and short-term paper, provided certain other conditions are met. Section 12(d)(1)(J) authorized the Commission to grant exemptions from the 3/5/10 limits in certain situations. In 2006, the Commission adopted Rule 12d1-2, which allows open-end funds relying on 12(d)(1)(G) also to invest in a broad range of other investments, including other investment companies, subject to certain limits.⁸

II. DISCUSSION

To rely on Section 12(d)(1)(G), an open-end fund must, in relevant part, invest only in (1) other open-end funds that are part of the same “group of investment companies,” (2) Government securities and (3) short-term paper (collectively, “Permissible 12(d)(1)(G) Securities”).

Rule 12d1-2 expands Section 12(d)(1)(G), allowing open-end funds⁹ to invest in other securities beyond Permissible 12(d)(1)(G) Securities. Rule 12d1-2(a) provides, in relevant part, that:

(a) . . . **Notwithstanding** section 12(d)(1)(G)(i)(II) of the [1940 Act], a registered open-end investment company or a registered [UIT] that relies on section 12(d)(1)(G) of the [1940 Act] to acquire securities issued by another registered investment company that is in the same group of investment companies may acquire, in addition to Government securities and short-term paper:

(1) securities issued by an investment company, ***other than securities issued by another registered investment company that is in the same group of investment companies***, when the acquisition is in reliance on section 12(d)(1)(A) or 12(d)(1)(F)¹⁰ of the [1940 Act];

(2) securities (other than securities issued by an investment company); and

(3) securities issued by a money market fund, when the acquisition is in reliance on rule 12d1-1. (Emphasis added.)

Section 12(d)(1)(G) defines “group of investment companies” as “any 2 or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services.”

In addition to securities of non-investment company issuers and certain money market funds, Rule 12d1-2 allows an open-end fund relying on Section 12(d)(1)(G) to invest in securities issued by a

⁸ See Fund of Funds Release.

⁹ As defined in n. 1, above.

¹⁰ Section 12(d)(1)(F) of the 1940 Act permits a registered fund to acquire no more than three percent of another fund’s outstanding stock, subject to conditions. It is intended to permit a registered fund to take small positions in an unlimited number of other funds. See Fund of Funds Release at 36640.

registered investment company “*other than* securities issued by another registered investment company that is in the *same group of investment companies*,” subject to the limits under Section 12(d)(1)(A) or 12(d)(1)(F). Accordingly, Rule 12d1-2 permits an open-end fund that complies with Section 12(d)(1)(G) and the Rule to invest in closed-end funds within these limits. Because the Rule is intended to broaden the scope of investments for an investing open-end fund that relies on Section 12(d)(1)(G), there is no reason to believe that the Commission intended to restrict the scope of closed-end funds in which the investing fund may invest.

However, the absence of clarifying language in Rule 12d1-2 and the Fund of Funds Release suggests it is possible that, under an interpretation of the Rule, closed-end funds could also be deemed to be part of the investing open-end fund’s “group of investment companies,” as defined in Section 12(d)(1)(G), and thus be excluded from the investments permitted under Rule 12d1-2(a)(1).

We believe this reading is inconsistent with the purpose of the exemptions to expand the scope of Section 12(d)(1)(G) to allow legitimate fund of funds arrangements. We also are not aware of any policy reason that would justify excluding investments in closed-end funds that are in the same group of investment companies as the investing fund. If the Commission had intended to restrict investments in such closed-end funds, it would have explicitly said so.¹¹ And, we believe that interpreting “other than securities issued by another registered investment company that is in the same group of investment companies” in a manner that does not so restrict the closed-end funds that can be acquired in reliance on the Rule is fully consistent with the intent of the Commission in adopting the Rule.¹²

Indeed, the reference to “other than securities issued by another registered investment company that is in the same group of investment companies” could reasonably be read to refer only to funds in which an investing fund could already invest in beyond the 3/5/10 limits in reliance on Section 12(d)(1)(G) and is not meant to foreclose the ability to invest in affiliated closed-end funds. This is consistent with the fact that the relief under Section 12(d)(1)(G) is available only to open-end funds.

¹¹ Prior to adopting Rule 12d1-2, the Commission issued several exemptive orders to permit investments in unaffiliated open-end funds and other securities. *See, e.g.*, Scudder Kemper Investments, Inc., Investment Company Act Release No. 23691 (Feb. 11, 1999) (notice), Investment Company Act Release No. 23731 (Mar. 8, 1999) (order) and Nations Fund Trust, Investment Company Act Release No. 24781 (Dec. 1, 2000) (notice), Investment Company Act Release No. 24804 (Dec. 27, 2000) (order). The proposing release relating to Rule 12d1-2 referred to these orders and noted that the Commission was proposing to not only codify but also expand the relief provided in these orders. *See* Fund of Funds Investments, 68 Fed. Reg. 58226 (Oct. 8, 2003) at 58232. Consistent with this intent to expand fund of funds relief, the final rule also permits investments in closed-end funds.

¹² Such purchases also would be subject to otherwise applicable limitations, such as Section 12(d)(1)(C) and Section 17(a) (*i.e.*, securities would be purchased from an entity that is not an affiliated person (or an affiliate of an affiliated person) in secondary market transactions).

Therefore, it follows logically that closed-end funds need not be included in the definition of “group of investment companies” provided under Section 12(d)(1)(G).

We also believe that the legislative and regulatory history behind the adoption of Section 12(d)(1)(G) support this interpretation. The legislative history indicates that Section 12(d)(1)(G) was adopted to codify certain conditions contained in exemptive relief from the 3/5/10 limits issued by the Commission on a regular basis in the years leading up to the Section’s adoption.¹³ Those fund of fund exemptive orders issued prior to the adoption of Section 12(d)(1)(G) included a condition that the acquiring fund and the underlying funds would be from the same “group of investment companies” as defined in SEC Rule 11a-3—“any two or more registered *open-end* investment companies that hold themselves out to investors as related companies for purposes of investment and investor services.”¹⁴

III. CONCLUSION AND REQUEST FOR INTERPRETIVE GUIDANCE

Accordingly, we request that the staff of the Division of Investment Management of the Commission concur with our interpretation that the definition of “group of investment companies” as defined in Section 12(d)(1)(G)(ii), refers solely, for the purposes of Rule 12d1-2(a)(1) under the 1940 Act, to **open-end** funds, which would allow an open-end fund to invest in closed-end funds that are part of the same group of investment companies as the investing fund within the limits set forth in the Rule.

¹³ See *Investment Company Act Amendments of 1995: Hearing on H.R. 1495 Before the Subcomm. on Telecommunications and Finance*, 104th Cong. 36 (1995) (statement of Barry P. Barbash, Director, Division of Investment Management, SEC, “The Commission has recently granted individual exemptions from the [1940 Act’s] restrictions to fund of fund arrangements that operate under conditions designed to address the concerns upon which the restrictions were premised. The legislation would incorporate certain of these conditions and would enable fund of fund arrangements that comply with those conditions to be offered without obtaining prior exemptive relief from the Commission.”).

¹⁴ See *Twentieth Century Blended Portfolios, Inc., et al.*, Investment Company Release No. 21813 (Mar. 11, 1996) (notice), Investment Company Act Release No. 21875 (Apr. 1996) (order); *T. Rowe Price Spectrum Fund, Inc., et al.*, Investment Company Release No. 21371 (Sept. 22, 1995) (notice), Investment Company Act Release No. 21425 (Oct. 18, 1995) (order); *Qualivest Funds, et al.*, Investment Company Act Release No. 21874 (Apr. 5, 1996) (notice), Investment Company Act Release No. 21933 (May 1, 1996) (order).

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If you have any questions please feel free to contact me at 202-261-3451 or Julien.Bourgeois@dechert.com, or Stephen T. Cohen at 202-261-3304 or Stephen.Cohen@dechert.com.

Sincerely,



Julien Bourgeois

cc:

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