

## **SEC Fund-of-Fund Rule Proposal: Potentially Disruptive Impact of Redemption Limitation**

As we touched upon briefly in our [previous post](#) on the SEC's recent Fund-of-Fund ("FOF") [rule proposal](#), proposed Rule 12d1-4 includes a provision that would limit an acquiring fund's ability to redeem shares of an acquired fund. Specifically, proposed Rule 12d1-4(b)(2) would prohibit a fund that acquires more than 3% of an acquired fund's outstanding shares from attempting to redeem more than 3% of the acquired fund's shares in any 30-day period. Unlike most current exemptions from Section 12(d)(1), this limitation would apply to acquiring and acquired funds that are part of the same group of investment companies. However, the release asked for comments on whether to exempt funds within a group of investment companies from the limitation on redemptions.

### **SEC's Rationale for a Limitation on Redemptions**

In its proposing release, the SEC stated that this 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. The release did not discuss other possible means of limiting an acquiring fund's influence, such as redemption in-kind.

### **Potential Problems with a Limitation on Redemptions**

The redemption limitation could cause timing issues for FOFs relying on the proposed rule. By the SEC's own estimation in the proposing release, if an acquiring fund held 25% of the outstanding shares of an acquired fund (the largest investment permitted outside the acquiring fund's group of investment companies), it would take ten months for an acquiring fund to fully unwind its investment. The proposed rule's redemption limitation could thus limit FOFs from being able to make investment allocation changes or respond to shareholder redemption requests in a timely fashion. The proposed redemption limitation could also cause issues for FOFs attempting to comply with the SEC's Liquidity Rule ([Rule 22e-4](#)), which will [go into effect for larger fund groups](#) on June 1, 2019. In general, the Liquidity Rule limits a registered fund's illiquid investments to 15% of the fund's portfolio. The Liquidity Rule defines an "illiquid investment" as any investment that cannot be sold within seven calendar days. By virtue of its redemption limitation, proposed Rule 12d1-4 would cause an acquiring fund's holdings in an acquired fund that are above the 3% threshold to be "illiquid investments." The combined effect of the Liquidity Rule and proposed Rule 12d1-4 would be to encourage FOFs to invest in much larger acquired funds, so that an FOF could invest a large percentage of its assets into an acquired fund without exceeding 3%. It may also make it difficult for a sponsor to start a new FOF using newly established acquired funds. Finally, substantial net redemptions by other shareholders of an acquired fund may cause an acquiring fund's illiquid investments to increase. This is because the percentage of shares held by the acquiring fund would increase as the acquired fund gets smaller, even though there would be no change in the number of shares held by the acquiring fund. The SEC did point out the potential tension between the proposed FOF rule's redemption limitation and the Liquidity Rule in a footnote of the proposing release. The release did not discuss these potential consequences, however, and the SEC did not solicit comments on the issue or propose any possible exceptions.

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