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SEC’s Division of Investment Management Clarifies Certain Questions on Fund of Funds Rule

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On March 5, 2026, the staff of the SEC's Division of Investment Management (the "Staff") published four new frequently asked questions (the "FAQs") addressing Rule 12d1-4 under the Investment Company Act of 1940 (the "1940 Act"), the comprehensive rule governing fund of funds arrangements adopted by the SEC in October 2020. The FAQs offer guidance on the scope of fund of funds investment agreement requirements and confirm that acquired funds do not have to count investments in debt securities issued by collateralized loan obligations ("CLOs") towards the 10% limit in Rule 12d1-4(b)(3)(ii). For registered investment companies (“RICs”), business development companies ("BDCs"), and their advisers, the FAQs contain both confirmations of industry practice and an expansion of investment latitude.

Section 12(d)(1)(A) of the 1940 Act imposes three well-known limits on fund of funds investments: (i) an acquiring fund may not own more than 3% of an acquired fund's outstanding voting securities (the "3% limit"); (ii) an acquiring fund may not invest more than 5% of its total assets in any single acquired fund (the "5% limit"); and (iii) an acquiring fund may not invest more than 10% of its total assets in acquired funds in the aggregate (the "10% limit"). Rule 12d1-4, adopted in October 2020, permits RICs and BDCs to exceed these limits without obtaining an exemptive order, subject to a series of conditions designed to prevent undue influence, fee layering, and the creation of overly complex multi-tier structures.

Key Takeaways

Fund of funds investment agreements are required whenever a fund relies on Rule 12d1-4, even if the 3% ownership limit is not exceeded. The Staff confirmed that an acquiring fund must execute an agreement with an acquired fund before purchasing securities in reliance on Rule 12d1-4, regardless of whether the acquisition would breach the 3% limit of Section 12(d)(1)(A)(i) of the 1940 Act. This means that funds relying on Rule 12d1-4 solely to exceed the 5% or 10% asset concentration limits of Section 12(d)(1)(A)(ii) or (iii) must still have a fund of funds investment agreement in place, even though no findings are required under Rule 12d1-4(b)(2)(i) in that scenario.

Unit investment trusts ("UITs") are not exempt from the agreement requirement. UITs relying on Rule 12d1-4 must also enter into a fund of funds investment agreement, even if they remain below the 3% threshold with respect to a particular acquired fund, so long as the UIT is otherwise relying on Rule 12d1-4.

No retroactive agreement obligation for pre-existing holdings. An acquiring fund is not required to enter into an agreement with respect to acquired fund positions held before the acquiring fund began relying on Rule 12d1-4, unless the acquiring fund subsequently purchases additional shares of such an acquired fund in reliance on Rule 12d1-4.

Debt securities of collateralized loan obligation ("CLO") issuers don't have to be counted toward the 10% bucket. In a development of particular significance, the Staff indicated that it would not recommend enforcement action if an acquired fund excludes investments in debt securities issued by CLOs when calculating compliance with the 10% limit on investments in investment companies under Rule 12d1-4(b)(3)(ii). This position is significant for BDCs and credit-focused registered funds with substantial CLO debt exposure.

Additional Detail From the FAQs

Investment Agreement Requirement

Prior to the FAQs, there was some ambiguity about whether a fund of funds investment agreement was required in situations where the acquiring fund stayed below the 3% ownership limit but relied on Rule 12d1-4 only for purposes of exceeding the 5% or 10% asset concentration thresholds. The Staff resolved this question in FAQ 1, confirming that an agreement must be executed in all cases where the acquiring fund relies on Rule 12d1-4 to acquire securities of an acquired fund in excess of any of the three statutory limits. The Staff noted that where the acquiring fund does not exceed the 3% limit, the fund of funds investment agreement need not include "any material terms" tied to the findings that would otherwise be required, which means that agreements for such arrangements can be relatively streamlined. This guidance underscores the importance of having fund of funds investment agreements across all arrangements where Rule 12d1-4 is being relied upon.

FAQ 2 extended this same logic to UITs. Rule 12d1-4(b)(2)(iv) requires an acquiring UIT to enter into a fund of funds investment agreement with an acquired fund even if the UIT remains below the 3% threshold, so long as the UIT is otherwise relying on Rule 12d1-4.

No Agreement Required For Prior Purchases

FAQ 3 addressed a transitional question that has continued to arise in practice: whether a fund that begins relying on Rule 12d1-4 must execute agreements retroactively for positions it already held. The Staff confirmed that because Section 12(d)(1) of the 1940 Act is an "acquisition test," no agreement is required for holdings that predate the acquiring fund's reliance on the rule. However, if the acquiring fund subsequently purchases additional shares of an acquired fund in reliance on Rule 12d1-4, an agreement must be entered into before those additional purchases are made. Compliance programs should track whether and when new purchases of acquired fund securities are made in reliance on Rule 12d1-4 so that agreement obligations are triggered at the appropriate time.

CLO Debt Securities Excluded From the 10% Limit

Many CLO issuers rely on the exclusions in Section 3(c)(1) or Section 3(c)(7) of the 1940 Act. As result, they fall within the definition of "private fund" under Rule 12d1-4 and the securities of CLO issuers, including debt tranches, may count toward the 10% limit. However, the Staff clarified that CLO debt does not implicate the concerns that the conditions of Rule 12d1-4 are designed to address because CLO debt tranches are "backed by the cash flows of an underlying pool of collateral" and function as financing instruments rather than providing economic exposure to the underlying assets. Accordingly, the Staff indicated that it would not recommend enforcement action if an acquired fund does not count investments in CLO debt securities towards the 10% limit in Rule 12d1-4(b)(3)(ii). This relief does not extend to CLO equity tranches, which continue to count toward the 10% limit because they do provide economic exposure to the underlying collateral.

To learn more about the considerations for asset managers, please reach out to any of the authors.

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