ALERT MEMORANDUM

SEC Continues Focus on Reducing Inadvertent Regulatory Friction through Responses to Fund of Funds FAQs

March 12, 2026

In October 2020, the Securities and Exchange Commission (the SEC or Commission) adopted Rule 12d1-4 (the Fund of Funds Rule)[1] to provide an exemption from the restriction on investing in certain underlying registered funds and business development companies (BDCs) pursuant to Section 12(d)(1) of the Investment Company Act of 1940 (the 1940 Act)[2] in order to "streamline and enhance the regulatory framework applicable to fund of funds arrangements."[3] The Fund of Funds Rule created a framework by which a registered fund or BDC is permitted, subject to certain conditions, to acquire shares in another registered fund or BDC exceeding the limits imposed by Section 12(d)(1) without needing to obtain an SEC exemptive order.

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At the time the SEC adopted the Fund of Funds Rule, it found that "approximately 40% of all registered funds hold an investment in at least one fund."[4] Following the rule's adoption, fund managers raised numerous questions regarding its implementation. On March 5, 2026, the SEC's Division of Investment Management published responses to frequently asked questions (FAQs) related to the adoption of the Fund of Funds Rule.[5] The SEC's responses demonstrate its commitment to reducing inadvertent regulatory friction.

[1] 17 C.F.R. § 270.12d1-4 (2026).
[2] 15 U.S.C. §§ 80a-1 to 80a-64 (2018).
[3] Fund of Funds Arrangements, Securities Act Release No. 10,871, Investment Company Act Release No. 34,045, 85 Fed. Reg. 73924, 73924 (Nov. 19, 2020), available at https://www.sec.gov/files/rules/final/2020/33-10871.pdf.
[4] *Id*.
[5] *Fund of Funds Arrangements Frequently Asked Questions*, U.S. SEC. & EXCH. COMM'N, (Mar. 5, 2026), https://www.sec.gov/investment/fund-of-funds-faq [hereinafter *Fund of Funds FAQs*].

The Commission's Responses to FAQs

1. Is a Fund of Funds Investment Agreement required if an acquisition would not exceed the 3% bucket, but would exceed the 5% or 10% bucket?

Section 12(d)(1)(A) prohibits registered funds and BDC (and companies they control) from:

- Acquiring more than 3% of another registered fund or BDC's outstanding voting securities;
- Investing more than 5% of its total assets in any one registered fund or BDC; or
- Investing more than 10% of its total assets in other registered funds or BDCs generally.[6]

The SEC clarified that an acquiring fund must enter into a fund of funds investment agreement if it seeks to rely on the Fund of Funds Rule to exceed any of the three limitations in Section 12(d)(1). The requirement applies even if an acquiring fund's acquisition of an acquired fund would result in it exceeding the 5% limitation or the 10% limitation, but not the 3% limitation. The SEC also explicitly noted this requirement also applies to unit investment trusts.

However, in instances where the 3% limitation is not exceeded, a fund of funds investment agreement does not need to include "any material terms" related to the findings that would otherwise be required by Rule 12d1-4(b)(2)(iv),[7] as in these instances "no such terms exist."[8]

2. Is a Fund of Funds Investment Agreement required for funds acquired prior to relying on the Fund of Funds Rule?

The SEC clarified that Section 12(d)(1) is "an acquisition test."[9] Therefore, an acquiring fund is not required to enter into a fund of funds investment agreement with registered funds in which it had invested prior to relying on the Fund of Funds Rule. However, an agreement would be necessary should the acquiring fund purchase additional shares of such previously acquired funds in reliance of the Fund of Funds Rule.

3. Should acquiring funds count CLO-issued debt securities towards the 10% bucket?

The Fund of Funds Rule generally prohibits acquired funds from purchasing securities in a private fund if, immediately after such purchase, the acquired fund would own more than 10% of the total value.[10] The Fund of Funds Rule defines private funds to include companies that rely on exclusions in Sections 3(c)(1) or 3(c)(7) of the 1940 Act.[11]

Many issuers of collateralized loan obligations (CLOs) rely on these sections, which suggests that funds should count debt securities issued by CLOs towards the 10% bucket despite seemingly little relevance on the underlying purpose of the Fund of Funds Rule. As a response to this ambiguity, the SEC clarified that staff would not recommend enforcement action to the Commission under Sections 12(d)(1)(A), 12(d)(1)(B), 12(d)(1)(C), 17(a), 57(a)(1)–(2), or 57(d)(1)–(2) of the 1940 Act[12] if an acquired fund does not count investments in debt securities issued by CLOs towards the 10% bucket.

Key Takeaways

By publishing these responses, the SEC appears to remain focused on a broader initiative of addressing areas of inadvertent regulatory friction. The SEC continues its efforts to clarify rules to eliminate these points of frictions, including with respect to certain new and existing retail products.

CLOs, for example, have long caused unnecessary confusion. In its FAQ response, the SEC explained that the purpose of the Rule 12d1-4(b)(3)(ii) was "to avoid the investor confusion that can result from complex multi-tier fund

[6] 15 U.S.C. § 80a-12(d)(1)(A).
[7] 17 C.F.R. § 270.12d1-4(b)(2)(iv) (2026).
[8] *Fund of Funds FAQs*.
[9] *Id*.
[10] 15 U.S.C. § 80a-12(d)(1)(A)(iii).
[11] 15 U.S.C. §§ 80a-3(c)(1), (7).
[12] 15 U.S.C. §§ 80a-12(d)(1)(A)–(C), 80a-17(a), 80a-57(a)(1)–(2), 80a-57(d)(1)–(2).

structures as multi-tier structures can obfuscate the fund's investments, fees, and related risks."[13] With respect to CLOs, the SEC recognized that given "fundamental structural and operational features,"[14] such as backing by cash flows of an underlying pool of collateral and earning distributed principal and income on the financing costs of the collateral, a CLO is unlikely to raise such multi-tier concerns. Thus the SEC stated its staff would not recommend enforcement against an acquired fund that did not count investments in CLO-issued debt securities toward the 10% bucket. This response demonstrates the SEC's apparent willingness to address industry concerns[15] in the effort to eliminate inadvertent regulatory friction.

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[13] *Fund of Funds FAQs* (citation omitted).
[14] *Id*.
[15] *See e.g.*, *New SEC Staff Guidance Provides Needed Clarity for Funds*, INV. CO. INST. (Mar. 6, 2026), https://www.ici.org/news-release/new-sec-staff-guidance-provides-needed-clarity-for-funds ("This relief will allow funds that hold debt securities issued by CLOs to be included in target-date funds without artificial restrictions that funds holding similar securities, such as mortgage-backed securities, are not subject to. Leveling the playing field lets managers diversify their portfolios for the benefit of their investors free from unnecessary structural disadvantages. The FAQ is an important step towards the 'responsible retailization' that SEC Chairman Atkins and Director Daly seek.") (internal quotations omitted).