

individuals had an interest. In other cases, these individuals caused funds to direct underwriting and brokerage business to broker-dealers they controlled—often on terms favorable to the broker-dealer. Controlling persons also profited when fund shareholders paid excessive charges due to duplicative fees at the acquiring and acquired fund levels.⁴

The complex structures that resulted from pyramiding created additional problems for shareholders. These structures permitted acquiring funds to circumvent investment restrictions and limitations, and made it impossible for shareholders to understand who really controlled the fund or the true value of their investments.⁵ A fund shareholder might know that he owned shares in a fund that invested in equity securities of large companies without understanding that the large companies were large funds that exposed him to substantial risks associated with smaller issuers, foreign currencies, or interest rates.⁶

In response to these findings in the Investment Trust Study, Congress included in the Act a provision designed to restrict fund of funds arrangements. As originally enacted, section 12(d)(1) prohibited a registered investment company (and any companies it controlled) from purchasing more than five percent of the outstanding shares of any fund that concentrated its investments in a particular industry, or more than three percent of the shares of any other type of fund.⁷

Section 12(d)(1) proved flawed, however, because it did not prevent *unregistered* investment companies from acquiring the securities of *registered* funds. In the 1960s, Fund of Funds, Ltd., an unregistered fund operated in Geneva, Switzerland, began to exploit that flaw by marketing to members of the U.S. military stationed overseas shares of foreign investment companies that had controlling interests in several registered U.S. funds.⁸ Fund of Funds, Ltd. engaged in many of the

abusive activities identified in the Investment Trust Study. These included charging duplicative advisory fees at the acquiring and acquired fund levels, providing sales loads to an affiliated broker for each investment the acquiring fund made in an acquired fund, and directing brokerage business to an affiliate of the fund of funds (which then rebated half the commission).⁹ In addition, Fund of Funds, Ltd. could exert undue influence on the management of acquired funds by threatening advisers to those funds with large redemptions.¹⁰

In 1970, Congress revisited section 12(d)(1) of the Act. Among other things, it tightened the restrictions on funds of funds and extended them to unregistered funds that invest in registered funds.¹¹ Today, funds are subject to two sets of prohibitions. First, section 12(d)(1)(A) prohibits a registered fund (and companies or funds it controls) from—

- Acquiring more than three percent of a fund's voting securities;
- Investing more than five percent of its total assets in any one acquired fund; or
- Investing more than ten percent of its total assets in all acquired funds.¹²

Second, section 12(d)(1)(B) prohibits a registered open-end fund from selling securities to any fund (including unregistered funds) if, after the sale, the acquiring fund would—

- Together with companies and funds it controls, own more than three percent of the acquired fund's voting securities; or
- Together with other funds (and companies they control) own more than ten percent of the acquired fund's voting securities.¹³

By limiting the *sale* of registered fund shares to other funds, section 12(d)(1)(B) prevents the creation of a fund of registered funds regardless of the limitations of U.S. law to regulate the activities of foreign funds, such as Fund of Funds, Ltd. Together, these two provisions of section 12(d)(1) have proven quite effective in putting a stop to the abusive practices that

characterized previous fund of funds arrangements.

Congress recognized that these restrictions would have the effect of preventing legitimate fund of funds arrangements and has, over the years, created three exceptions under which different types of fund of funds arrangements are permitted today:

Conduit Arrangements. The Act permits arrangements under which a registered fund invests *all* of its assets in shares of one other fund so that the acquiring fund is, in effect, a conduit through which investors may access the acquired fund.¹⁴ The exception currently provided in section 12(d)(1)(E) was originally designed to preserve the arrangements under which periodic payment plan certificates were issued.¹⁵ Today, this section is relied upon by most insurance company separate accounts, which are organized as UITs,¹⁶ and invest the proceeds from the sale of interests in variable annuity and variable life insurance contracts in shares of a mutual fund.¹⁷ This exemption also is used by “master-feeder funds”—arrangements in which two or more funds with identical investment objectives pool their assets by investing in a single fund with the same investment objective. Investors purchase securities in the “feeder”

¹⁴ See 15 U.S.C. 80a–12(d)(1)(E).

¹⁵ The exception for periodic payment plan arrangements originally was set forth in section 12(d)(1)(B). Section 12(d)(1)(E) was added by the 1970 Amendments. See S. Rep. No. 184, *supra* note 11, at 31; 1970 Amendments, *supra* note 11, § 7 (codified at 15 U.S.C. 80a–12(d)(1)(E)). Section 12(d)(1)(E) permits a fund's acquisition of securities issued by another fund provided that (i) the acquiring fund's depositor or principal underwriter is a broker or dealer registered under the Securities Exchange Act of 1934, (or a person the broker-dealer controls), (ii) the security is the only investment security the acquiring fund holds (or the securities are the only investment securities the acquiring fund holds if it is a registered UIT that issues two or more classes or series of securities, each of which provides for the accumulation of shares of a different fund), and (iii) the acquiring fund is obligated (a) to seek instructions from its shareholders with regard to voting the acquired fund's securities or to vote the acquired fund's shares in the same proportion as the vote of all other acquired fund shareholders, and (b) if unregistered, to obtain Commission approval before substituting the investment security.

¹⁶ The Act defines a “unit investment trust” as a fund that (i) is organized under a trust indenture, contract of custodianship or agency, or similar instrument, (ii) does not have a board of directors, and (iii) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities, but does not include a voting trust. 15 U.S.C. 80a–4(2).

¹⁷ See Securities and Exchange Commission, Protecting Investors: A Half Century of Investment Company Regulation 373–74 (1992) (“1992 Study”); Request for Comments on Issues Arising Under the Investment Company Act of 1940 Relating to Flexible Premium Variable Life Insurance, Investment Company Act Release No. 13632 (Nov. 23, 1983) [48 FR 54043 (Nov. 30, 1983)].

⁴ See Investment Trust Study, *supra* note 2, pt. 3, ch. 7, at 2725–39, 2760–75.

⁵ See *id.* at 2776–77 (discussing examples of fund investment policy changes that conformed to management interests), 2781–82 (discussing examples of management policies that resulted in confusing or misleading asset valuations).

⁶ See *id.* at 2721–95.

⁷ See Pub. L. No. 76–768, 54 Stat. 789, 809–10 § 12(d)(1) (1940) (codified at 15 U.S.C. 80a–12(d)(1) (1940)).

⁸ See H.R. Rep. No. 1382, 91st Cong., 2d Sess., 23 (1970) (“H.R. Rep. No. 1382”); Charles Raw, *et al.*, Do You Sincerely Want to be Rich? 61–66 (1971). Fund of Funds, Ltd. was incorporated in Ontario, Canada. See Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess., 312–24 (1966) (“1966 Study”).

⁹ See *Arthur Lipper Corp. et al. v. SEC*, Securities Exchange Act Release No. 11773, 46 S.E.C. 78 (Oct. 24, 1975), *sanction modified*, 547 F.2d 171 (2d Cir. 1976).

¹⁰ See 1966 Study, *supra* note 8, at 315–16.

¹¹ See Pub. L. No. 91–547, 84 Stat. 1413, 1417 § 7 (1970) (“1970 Amendments”) (codified at 15 U.S.C. 80a–12(d)(1)(A)). See also Sen. Rep. No. 184, 91st Cong., 1st Sess., at 31 (1969) (“Sen. Rep. No. 184”).

¹² See 15 U.S.C. 80a–12(d)(1)(A). If the acquiring fund is not registered under the Act, the prohibitions apply only with respect to its acquisition of securities in funds that are registered under the Act.

¹³ See 15 U.S.C. 80a–12(d)(1)(B).