

May 2, 2019

Via Electronic Filing

Ms. Vanessa Countryman
Acting Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Fund of Funds Arrangements (File No. S7-27-18)

Dear Ms. Countryman:

The Investment Adviser Association¹ (**IAA**) appreciates the opportunity to comment on the SEC's proposal regarding fund of funds arrangements.² Many of our members are advisers and/or sub-advisers to SEC-registered investment companies (**funds**) and are therefore significantly affected by the proposal. We appreciate the SEC's efforts to create a more consistent and efficient regulatory framework for fund of funds arrangements. We have significant concerns, however, about the disruptive impact that the limit on redemptions in proposed Rule 12d1-4 under the Investment Company Act of 1940 (the **Act**) would have on fund management to the detriment of funds and fund shareholders. We urge the SEC to consider adopting alternative approaches that satisfy the SEC's policy goals without impairing fund management. We also urge the SEC to permit private funds and foreign funds to rely on the rule. Our comments are limited to these two aspects of the Proposal.

I. The Proposed Limit on Redemptions Would be Extremely Disruptive and Could Disadvantage Fund Shareholders

In order 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,”³ proposed Rule 12d1-4(b)(2) would prohibit an acquiring fund that acquires more than three percent of an acquired fund's outstanding shares from redeeming or submitting for redemption, or tendering for

¹ The IAA is a not-for-profit association dedicated to advancing the interests of SEC-registered investment advisers. The IAA's member firms manage more than \$25 trillion in assets for a wide variety of individual and institutional clients, including pension plans, trusts, mutual funds, private funds, endowments, foundations, and corporations. For more information please visit our website: www.investmentadviser.org.

² *Fund of Funds Arrangements*, SEC Rel. No. 33-10590 (Dec. 19, 2018) (**Proposal**), available at <https://www.sec.gov/rules/proposed/2018/33-10590.pdf>.

³ Proposal, at Section II.C.2.

repurchase, more than three percent of an acquired fund's total outstanding shares in any 30-day period. The proposed redemption limit would not apply to sales of shares of an acquired fund by an acquiring fund in the secondary market. We urge the SEC to reconsider the proposed redemption limit because its harmful effects would substantially outweigh any potential benefits. These harmful effects include arbitrary and unjustified constraints on portfolio management, inequitable treatment of acquiring funds relative to non-fund shareholders, negative consequences on an acquiring fund's liquidity and its compliance with the liquidity risk management rule, detrimental impact on smaller funds, and substantially increased compliance burdens, among others. We are not aware of any evidence that the current approach to fund of funds redemption arrangements is not working and we thus do not believe that the proposed change is justified or necessary.

First, the proposed redemption limit would be widely disruptive to the management of current fund of funds arrangements and would harm fund of funds shareholders. Fund portfolio managers, including those of acquiring funds, are required to manage fund investments in the best interest of the funds and their shareholders and in accordance with fund investment objectives. Funds of funds could be prevented from doing so if they cannot redeem shares of acquired funds at the time and in the amount that they deem appropriate for effective fund management. Indeed, the SEC acknowledges in the Proposal that the redemption limitation "would limit funds' investment flexibility because it would reduce a fund's ability to quickly change its portfolio."⁴

Acquiring funds, like other fund shareholders, should be permitted to redeem from an acquired fund in excess of the proposed three percent limit. Effective fund management may call for redemptions beyond this limit under a number of circumstances, including, for example, due to changes in portfolio management or investment strategy, or in response to changes in the market. Acquiring funds also may need to redeem shares of acquired funds in excess of the three percent limit due to redemptions by acquiring fund shareholders. In addition, many acquiring funds are target date funds whose investments change based on a glide path that is disclosed to shareholders. Target date funds need to redeem shares at set points in time to adjust their portfolios to reflect that glide path. Requiring a target date fund to spread its redemptions over longer periods of time could hinder its ability to manage its allocation consistent with its glide path. Finally, from a practical standpoint, acquiring funds may not have daily information on the size of an acquired fund, making compliance with the proposed three percent limit very challenging.⁵

⁴ Proposal at Section VI.C.1.a.

⁵ The SEC describes the extensive compliance costs related to the proposed redemption limit. Ongoing compliance costs identified by the SEC "include (i) continuous monitoring of fund redemptions and the percentage of acquired fund shares that the acquiring fund owns; (ii) periodic review of the policies and procedures put in place to monitor the redemption limit; (iii) system maintenance; and (iv) additional staff training." Proposal at Section VI. C.1.c.

Second, the proposed redemption limit raises significant concerns about the liquidity of investments in acquired funds. Rule 22e-4 under the Act, the recently-adopted liquidity risk management rule, requires open-end funds to treat as “illiquid” securities that cannot be sold or disposed of in seven calendar days or less. In the Proposal, the SEC states that “[a]n acquiring fund that holds more than three percent of an acquired fund’s total outstanding shares should take this [redemption] limitation into account when classifying this portfolio investment as part of its liquidity risk management program under [Rule 22e-4].”⁶ An acquiring open-end fund could thus be required to treat shares issued by acquired open-end funds as illiquid due to the redemption limit, even though these funds offer daily redemptions to all shareholders and each acquired fund *is itself* subject to Rule 22e-4. It is inappropriate to require an acquiring fund to treat as illiquid an investment in an acquired fund that would be highly liquid without this artificial constraint and that also has its own liquidity risk management program.

Finally, the proposed redemption limit would have a negative impact on smaller funds. Acquiring funds would be much less likely to purchase shares of smaller funds, and more likely to invest in ETFs (whose shares are traded in the secondary market and are not subject to the redemption limit) and larger funds because of concerns about quickly reaching the three percent redemption limit, especially without any method to determine precisely whether the limit has been reached. Acquiring funds and their shareholders would lose out on potentially beneficial investments in smaller funds due to the proposed redemption limit, and the smaller funds would lose out on the capital provided by those investors.

II. Certain Alternatives to the Proposed Redemption Limit Would Address the SEC’s Concerns and Would be Far Less Disruptive

The SEC should consider alternatives to the proposed redemption limit that would address its concerns but be far less disruptive to current and future fund of funds arrangements. First, a redemption limit is unnecessary for funds that invest in funds within the same group of investment companies. Section 12(d)(1)(G) of the Act currently governs funds that invest beyond the limits of Section 12(d)(1) in other funds within the same group of investment companies, and it does not include a redemption limit. Affiliated fund of funds arrangements have operated under Section 12(d)(1)(G) for over 20 years with no evidence of abuse and with minimal risk of undue influence. When funds are part of the same group of investment companies, we believe there is no incentive to place one fund’s interests ahead of another.

Second, for fund of funds arrangements where the acquiring and acquired funds are not part of the same group of investment companies, the SEC should instead use an approach consistent with fund of funds exemptive orders. For example, the SEC could require an acquiring fund and acquired fund to execute a standard participation agreement prior to an initial investment by the acquiring fund in reliance on the rule. The SEC could require this agreement to include appropriate provisions, such as the identity of the acquiring fund(s) and acquired

⁶ Proposal, note 128.

fund(s), a representation that the investment would be in compliance with Rule 12d1-4, and provisions that address undue influence. Unlike the proposed redemption limit, a standard participation agreement or another approach consistent with existing SEC exemptive orders would not disrupt fund of funds portfolio management.

III. Private Funds and Foreign Funds Should be Permitted to Rely on the Proposal

Under proposed Rule 12d1-4, companies that rely on the exclusion from the definition of “investment company” in Section 3(c)(1) or Section 3(c)(7) of the Act (**private funds**) and funds domiciled outside the United States (**foreign funds**) are not included in the rule’s definition of “acquiring funds.” The Proposal provides that these types of funds are not included because they are not registered with the SEC, are not subject to reporting requirements under Form N-PORT or Form N-CEN, and are not subject to the Act’s recordkeeping requirements. The SEC intends for private funds and foreign funds to continue to have to seek exemptive relief rather than be permitted to rely on Rule 12d1-4.

We believe that private funds and foreign funds should be permitted to rely on proposed Rule 12d1-4 without having to obtain exemptive relief from the SEC. The rule’s provisions, with the changes to the redemption provision discussed above, would provide adequate protections to fund of funds arrangements where an acquiring fund is a private or foreign fund. To the extent that the SEC is concerned about reporting and recordkeeping by private and foreign funds, the SEC could require a private fund relying on the rule to be advised by an SEC-registered investment adviser. For a foreign fund, the SEC could require that the fund be advised by an SEC-registered investment adviser or an investment adviser controlling, controlled by, or under common control with an SEC-registered investment adviser.⁷ While we believe that the conditions under the rule would be sufficient to protect acquired funds, limiting the rule to funds advised by these advisers could add an additional layer of protection that should address the SEC’s concerns.

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⁷ We also note that the SEC Staff has taken the position that a foreign fund that uses U.S. jurisdictional means in the offering of its securities and that relies on Section 3(c)(1) or 3(c)(7) of the Act would be permitted to invest in registered funds to the same extent as private funds. *See* Dechert LLP, SEC Staff No-Action Letter (Jan. 25, 2017). If the SEC does not permit foreign funds to rely on Rule 12d1-4, the relief outlined in the Dechert letter should be preserved.

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U.S. Securities and Exchange Commission
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We appreciate the SEC's consideration of our comments. Please do not hesitate to contact the undersigned or Sarah Buescher at (202) 293-4222 if we may be of further assistance.

Respectfully,

A handwritten signature in black ink, consisting of a series of loops and a long horizontal stroke extending to the right.

Gail C. Bernstein
General Counsel

cc: The Honorable Jay Clayton, Chairman
The Honorable Robert J. Jackson Jr., Commissioner
The Honorable Hester M. Peirce, Commissioner
The Honorable Elad L. Roisman, Commissioner
Dalia Blass, Director, Division of Investment Management