IDC
INDEPENDENT DIRECTORS COUNCIL
Committed to Strong Fund Governance

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May 1, 2019

Ms. Vanessa Countryman
Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

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

Dear Ms. Countryman:

The Independent Directors Council[1] appreciates the opportunity to comment on the Commission's fund of funds proposal.[2] In fund of funds arrangements, directors represent the interests of both acquiring fund shareholders and acquired fund shareholders and have a keen interest in proposals affecting these arrangements. We commend the Commission for seeking to streamline the applicable regulatory framework for funds of funds. We also appreciate and fully support the proposal to recalibrate directors' responsibilities so that they would serve in an oversight role and not be called upon to make specific determinations regarding the arrangements.

While we are generally supportive of the proposal, we oppose one of the key conditions in the proposed rule—a redemption restriction. This proposed new condition is not part of the current regulatory framework and has not been tested in the market, like the current approach. We believe that the proposed new condition would significantly disrupt current fund of funds arrangements and that fund shareholders would suffer adverse consequences from it. We urge the Commission to reconsider this condition and adopt an approach that is more consistent with the current regulatory framework, which would fulfill the Commission's policy goals while allowing funds of funds to continue to successfully operate as they have for more than twenty years.

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[1] IDC serves the US-registered fund independent director community by advancing the education, communication, and policy positions of fund independent directors, and promoting public understanding of their role. IDC's activities are led by a Governing Council of independent directors of Investment Company Institute member funds. ICI is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds ("ETFs"), closed-end funds, and unit investment trusts in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI's members manage total assets of US$22.6 trillion in the United States, serving more than 100 million US shareholders, and US$6.6 trillion in assets in other jurisdictions. There are approximately 1,700 independent directors of ICI-member funds. The views expressed by IDC in this letter do not purport to reflect the views of all fund independent directors.

[2] *See* Fund of Funds Arrangements, Release Nos. 33-10590 and IC-33329 (December 19, 2018) (the "Release"), available at https://www.sec.gov/rules/proposed/2018/33-10590.pdf.

Background

The Commission is proposing new rule 12d1-4 under the Investment Company Act of 1940 ("1940 Act") to streamline and enhance the regulatory framework for fund of funds arrangements. The proposed rule would, under specified circumstances, permit a fund to acquire shares of another fund in excess of the limits of section 12(d)(1) of the 1940 Act without obtaining an exemptive order from the Commission. Section 12(d)(1) limits the ability of a fund to invest substantially in shares of another fund. Congress enacted the restriction because it was concerned about "pyramiding," a practice under which investors in the acquiring fund could control the assets of the acquired fund and use those assets to enrich themselves at the expense of acquired fund shareholders. Control could be exercised either directly (such as through the voting power of a controlling interest) or indirectly (such as coercion through the threat of large-scale redemptions). Congress also was concerned about the potential for excessive fees when one fund invested in another and the formation of overly complex structures that could be confusing to investors.

The views of Congress and the Commission have evolved over the years as fund of funds structures developed to include investor protections and serve purposes that benefit shareholders. Congress created statutory exemptions and the Commission adopted rules and issued exemptive orders permitting fund of fund arrangements in certain circumstances.[3] These regulatory advancements have facilitated the growth of fund of funds arrangements, including target date funds, which are a popular option for those saving for retirement in 401(k) plans and individual retirement accounts (IRAs). The combination of statutory exemptions, rules, and exemptive orders has created a dispersed regulatory framework, which has led to some substantially similar fund of funds arrangements being subject to different conditions.

Proposed Rule 12d1-4 Overview

The Commission is proposing new rule 12d1-4 to create a more consistent and efficient regulatory framework for fund of funds arrangements. The new rule would replace rule 12d1-2 and many of the exemptive orders.[4] It would permit a registered investment company or business development company ("BDC") to acquire the securities of any other registered investment company or BDC in excess of the limits in section 12(d)(1), subject to conditions that are designed to address pyramiding and other concerns underlying section 12(d)(1).

The proposed conditions under the new rule are based on conditions in current exemptive orders but differ in some important ways. The Release includes a table that demonstrates how the conditions under the proposed rule differ from those under existing exemptive orders,

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[3] *See* sections 12(d)(1)(E), 12(d)(1)(F), and 12(d)(1)(G) under the 1940 Act and rules 12d1-1, 12d1-2, and 12d1-3 under the 1940 Act.

[4] In connection with the proposed rule, the Commission proposes to rescind rule 12d1-2 under the 1940 Act and most exemptive orders granting relief from sections 12(d)(1)(A), (B), (C), and (G) of the 1940 Act. The Commission also is proposing related amendments to rule 12d1-1 under the 1940 Act and Form N-CEN.

organized by the three main policy concerns of section 12(d)(1): (i) undue influence; (ii) complex structures; and (iii) the layering of fees.[5]

With respect to the undue influence policy concern, the Commission proposes to require a redemption restriction, replacing the requirements in current exemptive orders that the acquiring and acquired funds enter into participation agreements and that boards make certain findings and adopt procedures to prevent overreaching and undue influence by the acquiring fund. As discussed more fully below, although IDC supports the proposed recalibration of directors' responsibilities on this subject, we oppose the redemption restriction.

Regarding both the complex structures and layering of fees concerns, the proposed rule would require the acquiring fund's adviser (in cases where the acquiring fund is a management company) to evaluate the complexity of the structure and aggregate fees associated with the fund's investment in the acquired fund, and find that it is in the best interest of the acquiring fund to invest in the acquired fund, before investing in the acquired fund and at least annually thereafter (or with such frequency as the acquiring fund's board deems reasonable and appropriate). The acquiring fund's adviser would be required to report its finding and the basis for its finding to the acquiring fund's board. Under the proposed rule, fund boards would no longer be required to find that advisory fees are based on services provided that are in addition to, rather than duplicative of, the services provided by an adviser to an acquired fund. We agree with and support the Commission's proposed elimination of this condition in light of directors' existing fiduciary and oversight obligations.[6]

Proposed Redemption Restriction

As noted above, IDC opposes the proposed redemption restriction, which would restrict an acquiring fund's ability to quickly redeem or tender a large volume of acquired fund shares. More specifically, the proposed condition would prohibit an acquiring fund that acquires more than 3 percent of the outstanding voting securities of an acquired fund from redeeming, submitting for redemption, or tendering for repurchase, more than 3 percent of an acquired fund's total outstanding shares in any 30-day period.[7]

The proposed redemption restriction would be a new requirement and is not included in the current regulatory framework, which also was designed to address the policy concerns of section 12(d)(1), including undue influence. Currently, fund of funds arrangements within the

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[5] *See* Release, *supra* n. 2, at 30-31.

[6] The proposal also would no longer require the adviser to waive fees in certain circumstances. To address concerns about complex structures, the proposed rule also includes conditions designed to restrict fund of funds arrangements to two tiers (other than in limited circumstances) and that generally are more comprehensive than the conditions in current exemptive orders. The Commission should consider comments others make regarding this and other conditions in the proposed rule. *See, e.g.*, Letter from Paul Schott Stevens, President and CEO, ICI, to Vanessa Countryman, Acting Secretary, SEC (April 30, 2019) ("ICI Letter").

[7] This condition would not prevent or otherwise limit an acquiring fund from selling acquired fund shares (such as ETFs and closed-end funds) in secondary market transactions.

same group of funds rely on section 12(d)(1)(G) and rule 12d1-2, neither of which impose redemption restrictions. Fund of funds arrangements between funds that are not in the same group rely on exemptive orders that require a "participation agreement" between the acquiring and acquired funds under which they agree to fulfill their responsibilities under the exemptive order. In addition, under current exemptive orders, fund boards are required to make certain findings and adopt procedures to prevent overreaching and undue influence by the acquiring fund and its affiliates.

The Commission states that it believes that the redemption condition, together with the proposed control and voting conditions, are more protective than certain conditions currently found in the exemptive orders and may be objectively tested as part of a fund's compliance program.[8] It further states that replacing the current conditions with the proposed conditions would lower compliance costs and burdens and enhance investor protection for acquired funds.[9] The Commission does not cite, however, any problems associated with the conditions in existing orders for addressing undue influence and other policy concerns.

Although we appreciate the Commission's interest in placing directors in the more appropriate oversight role and in facilitating the compliance oversight of these arrangements, we believe that the redemption restriction would cause harm to both acquiring and acquired funds (and their shareholders, as discussed below) that outweighs any potential benefits for them. We, thus, oppose the redemption restrictions under the proposed rule and suggest an alternative approach, as discussed below.[10]

Redemption Restriction's Harm to Shareholders

Fund shareholders would suffer adverse consequences from the proposed redemption restriction. For example, an acquiring fund's adviser could be limited in its ability to manage the fund's portfolio of investments in the fund's best interests. The adviser would not be able to nimbly reduce exposure to the acquired fund as it deems appropriate, including to rebalance the fund's allocations or when the acquired fund is no longer a good investment for the acquiring fund (for whatever reason, such as poor performance), while other investors in the acquired fund could redeem shares without restriction. In a situation where an acquired fund is facing significant redemptions, the percentage of the acquiring fund's holdings could increase as other investors exit the fund. The redemption restriction could unnecessarily prevent the acquiring

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[8] Release, *supra* n. 2, at 48.

[9] *Id*. at 49.

[10] The Commission notes that it had previously proposed a redemption restriction as part of its 2008 ETF proposal and that IDC and others had supported it as a replacement for director-related and other conditions in existing exemptive orders. *See* Release, *supra* n. 2, at 52 and n. 131; see also Exchange-Traded Funds, Release No. IC-28193 (Mar. 11, 2008). As the Commission acknowledges, however, that proposal concerned fund investments in ETFs only, and most acquiring funds buy and sell ETF shares in secondary market transactions. Because an acquiring fund could still gain or reduce exposure to an ETF on the secondary market without restrictions, the 2008 proposed redemption restriction would not have impaired portfolio management capabilities and liquidity to the extent of the current proposed redemption restriction.

fund's adviser from managing this holding in a manner that is in the best interests of the fund and its shareholders.

The 30-day redemption restriction also could affect the acquiring fund adviser's management of liquidity risk. Depending on the facts and circumstances, the restriction might cause an acquiring fund to consider holdings in excess of 3 percent in an acquired fund to be wholly or partially illiquid, when such an investment would normally be considered highly liquid. This rule-imposed impairment on liquidity seems to be at odds with the Commission's recent liquidity risk management rule, which sought to promote effective liquidity risk management.

As for acquired funds, although the condition is intended to protect their interests, it could have the opposite effect. The redemption restriction could deter acquiring funds from making significant investments in acquired funds (*i.e.*, above the 3 percent threshold). Fund of funds arrangements often provide the acquired funds with more scalable asset levels, resulting in greater efficiencies and reduced operating expenses for an acquired fund's shareholders. A redemption restriction resulting in reduced investment in acquired funds could hurt acquired fund shareholders who otherwise would have benefited from the greater economies of scale obtained from acquiring fund investments.

Alternative Approach to Redemption Restriction

We suggest that, instead of requiring redemption restrictions, the Commission adopt an approach that is similar to the current regulatory framework. Under this approach, a fund of funds could continue to invest in funds within its same group without a redemption restriction if it begins to rely on rule 12d1-4. Funds not within the same group could comply with conditions similar to those in current exemptive orders. In particular, the rule could require the acquiring and acquired funds to enter into a participation agreement, as they do today. These agreements are a widely-accepted part of current arrangements and give the funds the ability to tailor the arrangements to their specific needs.

As for the board requirements under the current exemptive orders, we agree with the Commission's proposal to no longer require boards to make specific determinations in connection with these arrangements. Those requirements bring boards into the management process and are not necessary for boards to provide appropriate and diligent oversight. Instead, the investment adviser should make certain determinations regarding the arrangements and provide representations and reports to the board, for the board's oversight of the arrangements.[11]

[11] *See* ICI Letter, *supra* n. 6, for a more complete description of the alternative approach.

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If you have any questions about our comments, please contact Annette Capretta, Deputy Managing Director, at [redacted] or me at [redacted].

Sincerely,

Amy B.R. Lancellotta
Managing Director

cc: The Honorable Jay Clayton
The Honorable Robert J. Jackson Jr.
The Honorable Hester M. Peirce
The Honorable Elad L. Roisman

Dalia Blass, Director
Division of Investment Management