

GRACIE
Asset Management

Brad D. Wagner, Esq.
General Counsel and Chief Compliance Officer
Gracie Asset Management
757 Third Avenue, 7th Floor
New York, NY 10017
Direct: 212.527.8219
[REDACTED]

May 2, 2019

Via Electronic Submission

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:

Gracie Asset Management¹ submits this letter in response to a request for comment by the Securities and Exchange Commission (the “Commission”) in proposing Rule 12d1-4 (the “Proposed Rule” or “12d1-4”) under the Investment Company Act of 1940 (the “1940 Act”), governing the operation of fund of funds arrangements.² The comments we submit for the Commission to consider relate primarily to the exclusion of funds that rely on section 3(c)(1) or 3(c)(7) of the 1940 Act (“Private Funds”) from the Proposed Rule’s scope of acquiring funds, particularly as it relates to acquiring underlying exchange traded funds (“Underlying ETFs”).³ In

¹ P&S Credit Management, L.P., doing business as Gracie Asset Management, a Delaware limited partnership, is an indirect wholly-owned subsidiary of Moelis Asset Management, LP, a Delaware limited partnership, with its principal offices located at 757 Third Avenue, New York, New York 10017. Gracie Asset Management is registered with the Commission as an investment adviser under the Investment Advisers Act of 1940 (the “Advisers Act”).

² *Fund of Funds Arrangements*, Investment Company Act Release Number 33329, 84 Fed. Reg. 1286 (December 19, 2018) (the “Proposal”). The Proposal supersedes a 2008 rule proposal to permit registered funds to invest in exchange traded funds beyond the section 12(d)(1) limits. *Exchange Traded Funds*, Investment Company Act Rel. No. 28193, 73 Fed. Reg. 14618 (March 11, 2008) (the “2008 Proposal”).

³ An exchange traded fund (“ETF”) can be organized as an open-end management investment company or a unit investment trust (“UIT”). Shares of an ETF are listed and traded on a securities exchange.

sum, we believe that the Proposed Rule should be expanded to permit Private Funds to invest in Underlying ETFs, beyond the 12(d)(1) limits.

In the Proposal, the Commission notes that “[s]everal commenters on the 2008 proposal urged us to include Private Funds within that proposed rule’s scope.” The Commission further noted the many arguments presented by those commenters. We believe those arguments were correct in 2008 as they applied to the 2008 Proposal, and remain equally true as applicable to this Proposed Rule.

Concerns Underlying the Limits in Sections 12(d)(1)(A) and (B)

Congress intended that the restrictions in Section 12(d)(1)(A) and (B) of the Act address certain abuses perceived to be associated with the pyramiding of investment companies, including: (i) unnecessary duplication of costs (such as sales loads, advisory fees and administrative costs); (ii) diversification without any clear benefit; (iii) undue influence by a fund holding company over its underlying investment companies; (iv) the threat of large scale redemptions of the securities of the underlying investment companies; and (v) unnecessary complexity. The SEC identified these abuses in its 1966 report to Congress, titled Public Policy Implications of Investment Company Growth (the “PPI Report”).

The PPI Report describes certain potential abuses, such as duplication of costs and illusory diversification benefits, that an investing registered investment company and its shareholders should be protected from. Many of these concerns, however, are not present when a Private Fund acquires shares of a registered investment company. We submit that a Private Fund and its investors are not in need of the protections that otherwise are afforded to a registered investment company and its shareholders nor did Congress intend for the Commission to provide those protections. This is clearly demonstrated by the fact that a Private Fund is not limited as to how much of its portfolio may be invested in registered funds.⁴ If Congress had intended to protect shareholders of unregistered funds from (i) unnecessary duplication of costs, (ii) diversification without any clear benefit, and (iii) unnecessary complexity, Congress could have done so. Accordingly, we believe that the concerns that should be addressed by the Commission with respect to Private Funds being “acquiring funds” under the Proposed Rule are solely those that affect the acquired registered investment companies - - namely, the Private Fund exerting undue influence over acquired funds, both through voting and the threat of large scale redemptions of the shares.

1. No Undue Influence

As a general matter, we do not believe that expanding the scope of permissible acquiring funds to include Private Funds would present investor protection concerns regarding undue

⁴ Private Funds, when they are purchasing shares of a registered investment company, are only deemed to be investment companies for purposes of 12(d)(1)(A)(i) and (B)(i).

influence that the Proposed Rule's conditions would not address. There is nothing unique about a Private Fund that would make them more or less likely or able to exercise an undue influence over an underlying Fund. This, as discussed more fully below, is especially true for investments in Underlying ETFs.

Specifically, with respect to a Fund's investment in an Underlying ETF, under section (b)(1)(ii) of the Proposed Rule, if an acquiring fund and its advisory group, as that term is defined in the Proposed Rule, owned more than 3% of the Underlying ETF, the Fund and its advisory group would be required to vote its shares of the Underlying ETF in the manner prescribed by Section 12(d)(1)(E)(iii)(aa) of the Act. Any such voting restriction, whether triggered at 3%, as proposed in the Proposed Rule, or 25%, the limit used to define "control" in the Act, would apply equally, and provide the same protections, whether the acquiring fund were a registered fund or a Private Fund.

2. Threat of Large-Scale Redemptions

The PPI Report expresses the following three principal concerns about the threat large-scale redemptions by a fund holding company may have on an underlying fund: (i) underlying funds would need to retain excessive cash balances to satisfy large-scale redemption requests and the retention of excessive cash balances would be inconsistent with the interests of other underlying fund shareholders because the fund would not be fully invested in portfolio securities; (ii) management of a fund holding company may, through threat of redemption, induce deviations from the underlying fund's investment program or policies; and (iii) large-scale redemptions could burden shareholders with unnecessary capital gains and disrupt the orderly management of the underlying funds. We submit that the provision of the Proposed Rule limiting the amount of shares of an Underlying ETF that can be redeemed would apply equally, and provide the same protections, whether the acquiring fund were a registered fund or a Private Fund. Further, because we are specifically suggesting that the Proposed Rule should permit Private Funds be able to invest beyond the section 12(d)(1) limits in Underlying ETFs, for the reasons discussed below, large-scale redemptions do not pose a significant threat to the Underlying ETFs.

(a) Threat of Redemption Would Not Create Excessive Cash Balances

We do not believe the Underlying ETFs would be required to maintain excessive cash balances. Shares of ETFs are not individually redeemable; they trade in the secondary market. Generally, shares of an ETF are redeemable directly to the ETF only in large aggregations of shares known as "Creation Units" and only by certain broker-dealers known as "Authorized Participants." An acquiring fund, therefore, would sell its shares of an Underlying ETF in the secondary market, and not directly redeem those shares. Since secondary market trading activity occurs away from the Underlying ETFs, the portfolio management of an Underlying ETF would not be disrupted or even directly affected by the Fund's selling activities in the secondary market. Further, the vast majority of ETFs use an "in-kind" creation/redemption process that is

designed to permit ETFs to remain fully invested in portfolio securities. Therefore, Underlying ETFs using this process do not need to hold cash balances to fund potential redemptions and the Underlying ETFs' investment programs would not be disrupted by such large-scale redemptions. The Underlying ETFs, therefore, would not need to retain excess cash balances to meet redemption requests.

(b) Threat of Redemption Would Not Induce Deviations in Investment Policy

We also believe that neither an acquiring fund nor any of its affiliates would be able to exert undue influence over the Underlying ETFs or induce them to deviate from their investment program or policies. As discussed above, shares of the Underlying ETFs are traded in the secondary market and such market activity would not disrupt or even affect the management of the Underlying ETFs. In the case of an Underlying ETF that is organized as a UIT, there is no discretion to vary the UIT's investments. As to the Underlying ETFs that are organized as management companies, the vast majority of such ETFs track an index, leaving the investment advisers of such ETFs with very limited discretion to vary the ETFs' investment programs.

(c) Redemptions Would Not Generate Unnecessary Capital Gains or Disrupt Orderly Management

Even if increased sales of shares of Underlying ETFs in the secondary market lead to additional redemptions, we believe that such redemptions of Creation Units would not burden remaining Underlying ETF shareholders with unnecessary capital gains or disrupt the orderly management of the Underlying ETFs. Again, the vast majority of ETFs redeem Creation Units in-kind in exchange for the ETF's portfolio securities -- not cash. A pro rata portion of the ETF's portfolio securities is distributed to the redeeming shareholder. Thus, remaining shareholders would not be burdened with unnecessary capital gains. In addition, the management of the ETFs would not be disrupted.

Concerns Regarding Private Funds

While we believe the discussion above addresses the customary issues raised by registered funds seeking relief from Section 12(d)(1), in the Proposal, the Commission identified the following reasons why Private Funds would not be permitted to rely on the Proposed Rule:

- *Private funds are not registered with the Commission and would not be subject to the reporting requirements of a registered investment company – including reporting that a registered fund is in fact relying on the proposed fund of funds rule.*

We believe it would be reasonable for the Commission to limit acquiring funds to only those Private Funds that are advised by registered investment advisers and subject to the reporting requirements of Rule 204(b)-1 under the Investment Advisers Act of 1940 ("Advisers Act"). While those Private Funds are not registered under the Act, the Adviser would be

registered under the Advisers Act and would regularly file Form PF with the Commission, which would provide information about the Fund's investments.

- *Private Funds are not subject to the recordkeeping requirements of the Act, which may not allow the Commission to monitor compliance with the conditions of the proposed fund of funds rule.*

As stated above, we believe it would be reasonable for the Commission to limit acquiring funds to only those Private Funds that are advised by registered investment advisers. In that case, the investment adviser would be subject to the extensive recordkeeping requirements under the Advisers Act. Further, while the Private Fund would not be subject to the Act's reporting requirements, the Private Fund's investment adviser would be subject to the reporting on Form PF. Of course, the Underlying ETFs would be subject to the recordkeeping requirements of the Act. Finally, both the Underlying ETFs and the Private Fund's adviser would be subject to Commission oversight and inspection.

Although including Private Funds in the scope of "acquiring funds" in the Proposed Rule would be a shift from prior Commission positions, we believe that such a change is appropriate in the public interest and, with respect to Underlying ETFs, would provide additional benefits. For example, permitting a Private Fund to invest to a greater extent in Underlying ETFs provides additional liquidity providers to the secondary market, which will only enhance market efficiency with respect to shares of the Underlying ETFs.⁵ Further, the conditions in the Proposed Rule intended to protect the shareholders of Underlying ETFs would provide the exact same level of protection regardless of whether the acquiring fund is a Private Fund or a registered fund.

Concerns Regarding Types of Underlying Funds

In the Proposed Rule, the Commission stated that "[w]e believe that the universe of permissible fund of funds arrangements generally should not turn on the type of the funds in the arrangement." While we applaud this sentiment, and agree that acquiring funds should have a relatively level playing field regardless of their type, including Private Funds, we also believe that the Proposed Rule should apply the conditions of the Proposed Rule to Underlying Funds

⁵ See, e.g., the comment letter from the Vanguard Group, Inc. (June 19, 2008) on Proposed rules regarding Exchange-Traded Funds ("The additional trading volume generated by unregistered funds [investing in ETFs beyond the 12(d)(1) limits] is likely to lead to narrower spreads . . ."). See also, Gerasimos G. Rompotis, Active Versus Passive ETFs: An Investigation of Bid-Ask Spread, *The IUP Journal of Applied Finance*, Vol. 16, No. 3 (2010) at 7 ("increased market activity benefits investors by narrowing the deviations between prices offered by ETF seller and buyers"); Benito Sanchez & Peihwang Wei, *The Liquidity of Exchange Traded Funds*, *International Review of Applied Financial Issues and Economics*, Vol. 2, No. 4 (2010) at 624 ("empirical research generally finds that the bid-ask spreads is a decreasing function of trading volume"); Mingsheng Li et al., *Empirical Analysis of ETF Intraday Trading*, *Financial Services Review*, Vol. 21 (2012) at 157 ("the smaller spreads of benchmark ETFs are likely driven by the large trading volume, long-trading history, and large capitalization of these ETFs").

Vanessa Countryman, Acting Secretary
May 2, 2019
Page 6 of 6

only as needed for the protection of shareholders, not uniformly for the for the sake of uniformity. We believe, and it is self-evident given that virtually every ETF has sought and received relief from Section 12(d)(1) to be an Underlying Fund, that ETFs are uniquely designed to be underlying funds in a fund of funds structure. Because ETFs are exchange traded, only redeemable by broker dealers in large aggregations, and not subject to annual shareholder meetings, Underlying ETFs, much like money market funds,⁶ generally do not raise the same, or same level of, concerns as some other types of underlying funds.⁷

Conclusion

We respectfully request that the Commission consider the recommendations set forth above. Specifically, we request that Private Funds be included in the Proposed Rule's scope of acquiring funds, particularly as it relates to acquiring Underlying ETFs. We are prepared to meet and discuss these matters with the Commission and the Staff and to respond to any questions.

Sincerely,



Brad D. Wagner, Esq.
General Counsel and Chief Compliance Officer

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

James Palmisciano, Chairman and Chief Investment Officer,
Gracie Asset Management

⁶ See Rule 12d1-1.

⁷ For example, we note that a listed closed-end fund would likely have different concerns regarding undue influence than a mutual fund or a UIT.