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

**Re: Fund of Funds Arrangements
Investment Company Act Release No. 33-10590
File No. S7-27-18**

Dear Ms. Countryman:

The Vanguard Group, Inc. (“Vanguard”) appreciates the opportunity to comment on the Securities and Exchange Commission’s (the “Commission”) recent release proposing a new rule and related amendments to the regulatory framework governing fund of funds arrangements (the “Proposing Release”).¹ Vanguard is one of the world’s leading asset managers and manages over \$5 trillion in assets globally, including nearly 40 funds of funds with assets in excess of \$587 billion. We believe that funds of funds can simplify investing and reduce investment costs for investors. We believe that target date funds, in particular, are of critical importance to retirement investors. Their use in employer-sponsored and individual retirement plans has expanded dramatically over the past ten years to become the most widely used investment vehicle for participants in 401(k), 403(b), and 457 plans in the U.S.

Vanguard supports the Commission’s effort to streamline regulation in this important area and supports the adoption of a modernized rule that would permit a fund² to acquire shares of another fund in excess of the limits of Section 12(d)(1) of the Investment Company Act of 1940 (the “1940 Act”)³ without obtaining an exemptive order from the Commission. We commend the Commission for proposing Rule 12d1-4 (the “Proposed Rule”) and related regulatory modifications, although we recommend certain changes designed to address the concerns that we have. Our primary comments are discussed below:

- We support the Commission’s effort to adopt a single rule, like the Proposed Rule, that would provide a consistent set of conditions under which most funds of funds would operate. However, we strongly oppose the limitation in the Proposed Rule prohibiting an acquiring fund owning shares of an acquired fund in excess of the limits of Section 12(d)(1)(A)(i) of the 1940 Act from requesting a redemption exceeding 3% of the total outstanding shares of the acquired fund within any thirty-

¹ *Fund of Funds Arrangements*, Investment Company Act Release No. 33-10590 (Dec. 19, 2018).

² The use of the term “fund” here and throughout this letter refers to registered open-end investment companies.

³ 15 U.S.C. 80a-12(d)(1).

day period (the “Redemption Limit”).⁴ We believe the Redemption Limit could harm investors and have undesirable unintended consequences.

- The Redemption Limit should not apply to affiliated funds of funds.⁵
- If the Redemption Limit is not eliminated for affiliated funds of funds, we recommend that the Commission retain Rule 12d1-2⁶ and amend it to permit investments in all financial instruments, including those that may not be deemed securities under the 1940 Act (“non-securities”).⁷
- We recommend that the Commission consider alternatives to the Redemption Limit for unaffiliated funds of funds.
- We believe that a no-action letter permitting a foreign fund that invests in a U.S. fund to comply with Section 12(d)(1)(A)(i) but not Sections 12(d)(1)(A)(ii) and (iii) (the “2009 Letter”)⁸ is not inconsistent with the Proposing Release and should not be withdrawn.

I. The Redemption Limit could harm investors and have unintended consequences

We strongly oppose the Redemption Limit and believe it could harm both Vanguard fund investors as well as fund investors generally. While we share the Commission’s view on the importance of limiting an acquiring fund’s ability to exert undue influence over an acquired fund, we believe that the Redemption Limit would significantly impair the operations of funds of funds and negatively affect their shareholders. We are concerned that acquiring funds may limit their investments in acquired funds to ensure that they own less than 3% of the total outstanding shares of the acquired fund. We believe this would increase complexity and cost for investors in acquiring funds.

We also have significant concerns about the potential impact of the Redemption Limit on target date retirement funds and their investors. Target date funds simplify retirement investing for many retail investors and offer access to a diversified, professionally managed portfolio at a low cost. Vanguard’s target date funds currently have over \$456 billion in assets under management, and we estimate that for every dollar contributed to a workplace defined contribution plan in 2018, approximately 57 cents went into a target date fund. We believe that one of the most important attributes of target date funds is that they are structured to reduce an investor’s risk over time, which requires redemptions out of underlying equity funds and purchases of underlying bond funds over a retirement investor’s lifecycle. We believe that the Redemption Limit could impair the ability of a target date fund’s advisor to make these scheduled glide path changes to reduce portfolio risk, which would eliminate one of the core benefits of investing in a target date fund, to the detriment of many retirement investors.⁹

⁴ See Proposed Rule 12d1-4(b)(2).

⁵ The use of the term “affiliated fund of funds” here and throughout this letter refers to funds that are part of the same group of investment companies. “Group of investment companies” is defined under the Proposed Rule as “any two or more registered investment companies or business development companies that hold themselves out to investors as related companies for investment and investor services.” This is similar to the definition in Section 12(d)(1)(G) of the 1940 Act but is inclusive of closed-end funds and business development companies (“BDCs”). See Proposed Rule 12d1-4(d).

⁶ 17 CFR 270.12d1-2.

⁷ See 15 U.S.C. 80a-2(a)(36) (defining “security”).

⁸ Dechert LLP, SEC No-Action Letter (pub. avail. Aug. 4, 2009).

⁹ We think this problem would be likely to arise during periods of market volatility and when regular portfolio rebalancings have utilized the redemption capacity that would otherwise be used for planned glide path changes. In addition, we believe that other multi-asset funds of funds, which are frequently rebalanced to maintain their desired exposures to underlying equity and fixed income funds, may be particularly impacted by the Redemption Limit during periods of market volatility, as it may prevent necessary rebalancings for these funds.

We are also concerned that the Redemption Limit would prevent an acquiring fund that relies on the Proposed Rule from implementing certain strategy or allocation changes that are otherwise consistent with its investment policies. In recent years, Vanguard's multi-asset funds of funds have made strategy and allocation changes designed to benefit shareholders that have involved significant redemptions from acquired funds.¹⁰ We believe that Vanguard may be unable to make similar changes in the future for certain funds of funds if the Redemption Limit is adopted, to the detriment of investors.

The Redemption Limit could also impair the speed with which changes to funds of funds are implemented. For example, an advisor to an acquiring fund may determine that investing in an acquired fund is no longer optimal due to the inclusion of certain asset classes or a change in the advisor's thinking on portfolio construction, or the board of an acquiring fund may determine that it is in the best interests of an acquiring fund to immediately stop investing in an acquired fund due to performance concerns or concerns about the departure of key personnel of the acquired fund's advisor. The Redemption Limit could force the acquiring fund to remain invested in the acquired fund for many months, unnecessarily exposing shareholders of the acquiring fund to increased uncertainty, diminished performance, and to a sub-optimal allocation.

Finally, we note that the Redemption Limit could impact a fund of fund's liquidity risk management program under Rule 22e-4¹¹ by requiring that certain investments in acquired funds be deemed "illiquid," which could cause additional portfolio management challenges for funds of funds subject to the Proposed Rule.

II. The Redemption Limit should not apply to affiliated funds of funds

As noted above, we understand the Commission's policy objectives in limiting an acquiring fund's ability to exert undue influence over an acquired fund through the threat of a large-scale redemption. However, we believe that this concern does not exist for affiliated funds of funds, including when they invest in securities and non-securities.¹² We are particularly concerned with the application of the Redemption Limit to affiliated funds of funds and the resulting impairment of rebalancing transactions and restructuring transactions that may involve redemptions exceeding the Redemption Limit.

For an acquiring fund that would be subject to the Proposed Rule, but not subject to the control condition,¹³ it could take years to implement a decision to unwind a position in an acquired fund. By way of example, Vanguard offers an acquiring fund that would be subject to the Proposed Rule, but not subject to the control condition, that holds approximately 60% of an underlying Vanguard fund.¹⁴ We estimate that it would take

¹⁰ These changes were made during a historically strong market characterized by large cash inflows and therefore would not have triggered the Redemption Limit. In other market conditions not characterized by such large cash flows, additional redemptions of underlying funds could be necessary to rebalance portfolios or to make strategy or allocation changes and could trigger the Redemption Limit.

¹¹ 17 CFR 270.22e-4.

¹² We note that an acquiring fund relying on Section 12(d)(1)(G) may own an unlimited amount of an affiliated acquired fund and would not be subject to the Redemption Limit. However, as proposed by the Commission, if such a fund were to purchase a single security or non-security, it would become subject to the Proposed Rule and the Redemption Limit, which we believe is an incongruous result.

¹³ See Proposed Rule 12d1-4(b)(1).

¹⁴ The operation of this Vanguard fund of funds best illustrates our concern with the Redemption Limit's potential impact on a fund of fund's ability to meet shareholder redemptions. We estimate that it would take merely 5% in shareholder redemptions of the acquiring fund for it to need to exceed the Redemption Limit. If this acquiring fund could not redeem sufficient cash from the acquired fund to meet its obligations to its redeeming shareholders, it may be forced to honor a redemption in-kind, which would likely not be the type of redemption proceeds desired by the acquiring fund's redeeming shareholder(s). The Redemption Limit could similarly impact other acquiring funds that must rely on the Proposed Rule that own a significant portion of an acquired fund.

approximately 2.5 years for this acquiring fund to fully unwind its investment in the underlying fund, assuming there was no other shareholder activity during the period.¹⁵ Further, we note that because the acquiring fund and acquired fund are both part of Vanguard's group of investment companies, there is no risk of undue influence in this fund of funds arrangement that needs to be protected against.

We believe that the Proposed Rule's imposition of the Redemption Limit on affiliated funds of funds is contrary to the existing regulatory framework governing affiliated fund of funds and conflicts with Congress' and the Commission's historical position on affiliated funds of funds. The enactment of Section 12(d)(1)(G) in 1996 and the Commission's adoption of Rule 12d1-2 in 2006 each reflect a determination that affiliated fund of funds arrangements do not raise the same concerns as unaffiliated fund of funds arrangements. Neither Section 12(d)(1)(G) nor Rule 12d1-2 imposes a redemption limit on an acquiring fund. Further, we believe that this investment flexibility that has historically been given to affiliated funds of funds reflects the fact that when an acquiring fund and acquired fund are part of the same group of investment companies, the risk of an acquiring fund attempting to exert undue influence on the acquired fund is non-existent.

The Proposed Rule excepts funds of funds from the control and voting conditions when the acquiring fund and acquired fund are in the same group of investment companies.¹⁶ However, the Proposed Rule does not except affiliated funds of funds from the Redemption Limit on the basis that the acquiring fund would not be constrained in its ability to control an acquired fund and could acquire more than 25% of its outstanding voting securities.¹⁷ We think that this is an insufficient justification to apply the Redemption Limit to affiliated funds of funds.¹⁸ We believe that the same alignment of interests that eliminates the need for an affiliated fund of funds to be subject to the control and voting conditions of the Proposed Rule also eliminates the need for such a fund to be subject to the Redemption Limit condition.

We urge the Commission to reconsider the negative impact to an acquiring fund's operations that would result from imposing the Redemption Limit, taking into account the lack of any tangible benefit to the acquired fund in applying the Redemption Limit when the acquiring and acquired funds are part of the same group of investment companies. We believe the logical result of such consideration should be that the proposed exception for affiliated funds of funds from the control and voting conditions in the Proposed Rule is also extended to the Redemption Limit.

III. If the Redemption Limit is not eliminated for affiliated fund of funds, Rule 12d1-2 should be retained and amended to permit investments in all financial instruments

If the Commission does not see fit to eliminate the Redemption Limit for affiliated funds of funds in the Proposed Rule as we strongly recommend, then we recommend that the Commission retain Rule 12d1-2 and amend it to permit investments in all financial instruments, including non-securities. As noted, affiliated funds of funds have been operating for many years under a regulatory framework that permits investment flexibility and does not require compliance with a condition either similar to or as burdensome as the Redemption Limit. We believe that it is unnecessary to now require that these funds comply with the Redemption Limit in order to retain their investment flexibility, when Congress and the Commission

¹⁵ We acknowledge that funds of funds could invest their assets in additional underlying funds, with a smaller amount allocated to each fund, to reduce the likelihood that they would be impacted by the Redemption Limit. However, we think that there could be significant negative consequences to this alternative, as it could increase the complexity in the fund of fund's structure, reduce its transparency, potentially increase costs, and would introduce additional operational risk to the acquiring fund's manager.

¹⁶ Proposing Release at 41, 167.

¹⁷ Proposing Release at 167.

¹⁸ We note that Section 12(1)(G) does not contain any conditions as burdensome as a limit on redemptions and permits up to 100% ownership of an affiliated fund, subject to the conditions of that Section.

have been progressively increasing the investment flexibility available to these funds. We believe that retaining Rule 12d1-2 and amending it to permit investments in non-securities would be consistent with Congress' and the Commission's long-standing position that allowing investment flexibility for funds of funds that rely on Section 12(d)(1)(G) does not implicate the policy concerns underlying Section 12(d)(1).¹⁹ The Commission has also granted numerous exemptive orders permitting affiliated funds of funds to invest in non-securities.²⁰

IV. We suggest alternatives to the Redemption Limit for unaffiliated funds of funds

We also believe that there are less disruptive alternatives to the Proposed Rule's Redemption Limit that address the Commission's policy concerns with respect to unaffiliated funds of funds, such as codifying certain conditions in existing exemptive orders that provide relief from Section 12(d)(1)(A). We believe that this alternative would cause minimal disruption to the fund industry, would effectively address the Commission's policy concerns, and would further the Commission's goal of streamlining the regulation of fund of funds.

Specifically, we suggest that instead of a Redemption Limit, the Proposed Rule include requirements similar to the following for unaffiliated fund of fund arrangements:

- An acquiring fund and an acquired fund must enter into a participation agreement prior to the acquiring fund making an investment in the acquired fund in reliance on the Proposed Rule.
- Before entering into the participation agreement, the advisor to the acquiring fund must make the best interest determination set out in the Proposed Rule,²¹ and the advisor to the acquired fund similarly must make a determination that accepting the acquiring fund's investment is in the best interest of the acquired fund.
- The acquiring fund's advisor must execute and provide a certification to the acquired fund advisor stating that it will not invest in the acquired fund as a means to exert undue influence over the acquired fund or to influence any services or transactions. At the time of its investment in shares in the acquired fund in excess of the limit in Section 12(d)(1)(A), the acquiring fund must notify the acquired fund of its investment.
- The advisor to the acquired fund and the advisor to the acquiring fund must report to their respective boards periodically in connection with monitoring the participation agreement, but responsibility for making the best interest determination prior to entering into the agreement and any other issues relating to the agreement would be with each fund's advisor and not either fund's board.

¹⁹ When the Commission adopted Rule 12d1-2 in 2006, it noted that permitting a fund that relies on Section 12(d)(1)(G) to invest in securities other than those issued by a fund would allow greater investment flexibility, without presenting any additional concerns that Section 12(d)(1)(G) was intended to address. *Fund of Funds Investments*, Investment Company Act Release No. 27399 (June 20, 2006), at n.61 and accompanying text; *see also* Northern Lights Fund Trust, SEC No-Action Letter (June 29, 2015) ("Northern Lights Letter"). When the Commission proposed to amend Rule 12d1-2 in 2008 to allow the same funds to invest in assets other than securities, it noted that it had issued exemptive orders providing such relief, and that investments in these assets did not appear to raise concerns that the investment limits contained in section 12(d)(1) were intended to address. *Exchange-Traded Funds*, Investment Company Act Release No. 28193 (March 11, 2008) 85-86, n.260 and accompanying text. Although the 2008 amendment was not adopted, the Commission continued to issue exemptive orders providing such relief, and, in 2015, the Staff of the Commission issued no-action relief of the same nature. *See* Northern Lights Letter.

²⁰ *See e.g., In the Matter of Vanguard STAR Funds et. al.*, Investment Company Act Release No. 28024 (October 24, 2007).

²¹ *See* Proposed Rule 12d1-4(b)(3)(i).

By requiring the acquired fund's advisor to make a best interest finding prior to entering into the participation agreement, the acquired fund is given the opportunity to evaluate the potential investment prior to accepting it, and to reject the investment should the acquired fund's advisor believe that it could harm the fund. We believe that this opportunity to reject an investment, along with additional requirements noted above, would be more effective in protecting an acquired fund from undue influence than the Redemption Limit and would be much less disruptive to unaffiliated funds of funds and their investors.

V. We recommend that the Commission not withdraw the 2009 Letter

We support the Commission's effort to simplify the regulation of fund of funds arrangements, and acknowledge that certain no-action letters issued by the Commission's staff relating to Section 12(d)(1) that are inconsistent with the Proposing Release may be withdrawn. However, we believe that the 2009 Letter²² is not inconsistent with the Proposing Release and consequently should not be withdrawn.

Under the 2009 Letter, a foreign fund that invests in a U.S. fund must comply with Section 12(d)(1)(A)(i), which protects a U.S. fund and its shareholders, but not Sections 12(d)(1)(A)(ii) and (iii), which protect the investing fund and its shareholders, on the basis that the Commission has no significant regulatory interest in protecting a foreign investing fund and its shareholders. From a policy perspective, we believe that nothing has changed since 2009 that would cause the Commission to have a regulatory interest in enforcing the provisions of Sections 12(d)(1)(A)(ii) and (iii) for the protection of foreign funds and their shareholders. Moreover, we believe that the 2009 Letter is outside of the scope of the Proposed Rule because it addresses foreign funds, which are specifically excluded from the Proposed Rule.²³

Finally, we note that withdrawal of the 2009 Letter would harm Vanguard fund shareholders. Vanguard has 25 foreign funds with approximately \$10 billion in assets that rely on the 2009 Letter to invest in Vanguard's U.S. funds in excess of the limits of Section 12(d)(1)(A)(ii) and (iii). The relief in the 2009 Letter not only benefits Vanguard's foreign funds, but also benefits Vanguard's U.S. funds through economies of scale, which ultimately results in lower costs for Vanguard's U.S. fund investors. If the Commission sees fit to withdraw the 2009 Letter, we strongly urge the Commission to provide a mechanism in the Proposed Rule that would allow foreign funds to continue to invest in U.S. funds in excess of the limits of Section 12(d)(1)(A)(ii) and (iii) in order to avoid harming the many shareholders that would be impacted by the 2009 Letter's withdrawal.

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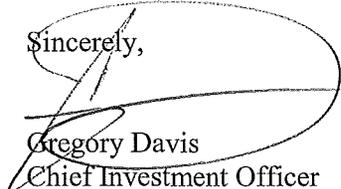
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²² Dechert LLP, SEC No-Action Letter (pub. avail. Aug. 4, 2009).

²³ Proposing Release at 20-22.

Vanguard appreciates the opportunity to submit these comments. If you have any questions or wish to discuss them in greater detail, please do not hesitate to contact Lance Barrett at [REDACTED].

Sincerely,



Gregory Davis
Chief Investment Officer
The Vanguard Group, Inc.

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

