May 2, 2019

Ms. Vanessa Countryman  
Acting Director  
Office of the Secretary  
U.S. Securities and Exchange Commission  
100 F Street NE  
Washington, DC 20549

Submitted electronically

Re: Fund of Funds Arrangements (Release Nos. 33-10590; IC-33329; File No. S7-27-18)

Dear Director Countryman:

The U.S. Chamber of Commerce’s Center for Capital Markets Competitiveness (CCMC) welcomes this opportunity to comment on the U.S. Securities and Exchange Commission’s (“SEC” or “Commission”) proposal regarding fund of funds arrangements (“Proposal”). As noted in the Proposal, fund of funds structures have evolved significantly over the years, so it is entirely consistent with the SEC’s mission to review and update as appropriate the regulatory framework that applies to such arrangements. While the Proposal represents an opportunity to modernize a number of existing rules, the CCMC does have concerns about certain provisions we believe could unduly inhibit the ability of fund managers to operate portfolios in a prudent manner.

As the SEC moves forward in considering the Proposal, the CCMC makes the following recommendations:

1) Business development companies (“BDCs”) should not be included in the definition of an “acquired fund” under Forms N-1A, N-2, N-3, N-4, and N-6, and therefore be exempt from the acquired fund fees and expenses (“AFFE”) requirement;
2) For funds that avail themselves of the updated investment thresholds under the Proposal, the SEC should reconsider limiting acquiring funds from redeeming more than 3% of the total outstanding shares of an acquired fund over a 30-day period. At a minimum, the SEC should exempt affiliated funds from such an arbitrary redemption limit.

3) The SEC should consider reviewing existing rules to address any regulatory loopholes that allow fund of funds arrangements to be structured for the purpose of evading ownership thresholds under the Investment Company Act of 1940; and

4) The SEC should not foreclose the availability of future exemptive relief or no-action requests for fund of funds arrangements and should be mindful not to rescind existing no-action relief not directly impacted by the Proposal.

Our views on these recommendations are provided in greater detail below.

1. Business development companies should not be included in the definition of an “acquired fund” under Forms N-1A, N-2, N-3, N-4, and N-6, and therefore be exempt from the acquired fund fees and expenses (“AFFE”) requirement.

Business development companies are a critical source of capital for small and medium-sized businesses throughout the United States. Since their creation by Congress in 1980, BDCs have offered a unique form of financing through a highly regulated investment vehicle available to retail investors. By law, BDCs are mandated to invest at least 70% of their assets in small and medium-sized businesses.

The role of BDCs has become particularly important over the last decade as the financial crisis, recession, and new regulations placed on the financial system have collectively made it more difficult for banks and other lenders to serve Main Street businesses.¹ Over the last fifteen years, BDCs have grown from a relatively small

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¹ Last month, the Chamber released a survey and report describing some of the difficulties that Main Street businesses have had in accessing capital and the regulations that are constraining the ability of the financial system to serve Main Street. The report found, for example, that 45% of businesses had to absorb the higher costs of banking services in recent years, while 66% reported that specific regulations such as bank capital charges have led to increased costs. The report is available at
industry to one with over 90 operating BDCs that have about $100 billion in assets under management.

Notwithstanding this organic growth in investment, the BDC regulatory framework remains outdated which has inhibited BDCs from fully serving American businesses. Congress took meaningful steps in 2018 when it passed legislation that updated the offering and proxy process for BDCs, and also allowed BDCs the option of modestly increasing their leverage in order to deploy more capital. Passage of these provisions was the result of a years-long, bipartisan effort in Congress to improve the regulatory environment for BDCs and their investors.

However, BDCs remain subject to the AFFE disclosure requirements which has directly resulted in both misleading disclosures to investors and an outflow of capital from BDCs in recent years. In 2006, the SEC adopted the AFFE requirement as part of a broader rulemaking to, as the adopting release explained, “provide investors with a better understanding of the actual costs of investing in a fund that invests in other funds.” The AFFE rule requires a fund to include as an additional line item in its prospectus fee table the pro rata share of the expenses of a fund it has acquired. This additional line item is coupled with the operating expenses of the acquiring fund to show that fund’s total expense ratio.

While the intent of the AFFE rule is to better inform investors about the expenses they pay under a fund of funds arrangement, the disclosure itself is fundamentally misleading and creates confusion for investors. The AFFE disclosure suggests that the expenses of an acquired fund (for example a BDC) are in addition to the operating expenses of the acquiring fund. In reality, the fees of an acquired BDC are indirect expenses that are not paid by the acquiring fund’s shareholders and are already reflected in the financial returns the BDC investment produces for the acquiring fund. As a result, subtracting a BDC’s expenses from its financial returns while adding them to the acquiring fund’s fee table “double counts” those expenses, thereby misinforming investors as to the true cost of investing in the acquiring fund.

As the Small Business Investor Alliance (SBIA) pointed out in a recent comment letter on the Proposal, several mutual fund companies have attempted to mitigate confusion by explaining via narrative disclosure the true expenses borne by


3 Fund of Funds Investments June 20, 2006. (Release Nos. 33-8713; IC27399)
shareholders of acquiring funds. However, given that investors are likely to use the prospectus fee table to assess the fees associated with a fund, it is unclear whether such additional disclosure actually mitigates investor confusion.

While the 2006 rule claimed that the AFFE requirement would not have “an adverse impact on capital formation,” the SEC soon realized that the rule was having negative consequences in the market. This led Commission staff to issue guidance in 2007 that had the effect of excluding certain investment vehicles from the definition of an “acquired fund” and, therefore, the AFFE requirements.

Additionally, the Commission has elected not to apply the AFFE requirement to real estate investment trusts (REITs), which have a similar structure to BDCs and, like BDCs, are generally actively engaged in the management of the entities in which they invest. BDCs and REITs also “pass-through” income to their investors and often have very similar fee structures. We do not believe there is a compelling public policy reason to treat REITs and BDCs differently in the context of AFFE; we believe that BDCs should be afforded the same exemption from these requirements.

In addition to creating a misleading disclosure for investors, the AFFE requirement has also directly led to an outflow of capital from BDCs in recent years. In 2014, several index providers made the decision to drop BDCs from certain indices because of the (at least perceived) impact that BDCs were having upon the reported expense ratios of mutual funds that invest in market indices. Because inclusion in an index generally increases the flow of capital into a stock or an investment fund, the exclusion of BDCs directly led to a market selloff of a number of funds and has limited investment flows into BDCs. While the decision to exclude BDCs from indices is understandable given the distortive effects of the AFFE requirements on expense ratios, there is little doubt that it has negatively impacted BDCs and their investors.

We believe it is fully within the Commission's authority and in the best interest of investors to provide an exemption for BDCs from the AFFE requirements. Congress has also taken note of this issue and included language in the FY2019

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4 Small Business Investor Alliance comment letter on Proposal April 30, 2019
Financial Services and General Government Appropriations bill that calls on the SEC to modernize the AFFE rule and to limit the adverse impact that AFFE has on BDCs. Members of both the House and Senate have also raised in hearings the distortive impact of AFFE on BDCs as an issue that the SEC should address. Such action by the SEC would improve investor disclosure and enhance the ability of BDCs to invest in small and medium-sized Main Street businesses throughout the country.

2. For funds that avail themselves of the updated investment thresholds under the Proposal, the SEC should reconsider limiting acquiring funds from redeeming more than 3% of the total outstanding shares of an acquired fund over a 30-day period. At a minimum, the SEC should exempt affiliated funds from such an arbitrary redemption limit.

Under existing rules, funds are limited in the amount of outstanding shares they can acquire of another fund; Section 12(d)(1) of the Investment Company Act of 1940 (“1940 Act”) generally limits that amount to 3% of the outstanding shares of the acquired fund. If an acquiring fund sought to invest above this 3% threshold, they can either seek exemptive relief from the SEC on certain grounds or rely on a narrow set of exemptions under the 1940 Act.

The Proposal effectively seeks to do away with all existing exemptive orders or portions of exemptive orders governing fund of funds, and would establish a more uniform regulatory framework for fund of funds arrangements. As part of this new framework under proposed Rule 12d1-4, registered funds would be permitted to invest above the 3% threshold subject to certain conditions that would limit the amount of control an acquiring fund could exert over an acquired fund. For example, a registered fund that acquires more than 3% of another fund would be required to utilize either pass-through or mirror voting to vote the shares of the acquired fund. Additionally, an acquiring fund and its related advisory group would be prevented from “controlling” (as defined by the 1940 Act) an acquired fund.

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Under the Proposal, an acquiring fund that takes a greater than 3% stake in another fund would also be prohibited from redeeming more than 3% of the total outstanding shares of the acquired fund over a 30-day period. According to the Proposal, these redemption limits are intended to prevent an acquiring fund from “threatening to quickly redeem or tender a large volume of an acquired fund shares as a means to exert undue influence over an acquired fund.”

While the SEC is understandably concerned about situations where an acquiring fund takes a significant position in another fund in order to exert undue influence and create a short-term gain at the expense of other shareholders, we believe that establishing an arbitrary redemption limit is not the best way to protect against such outcomes. Acquiring funds may find themselves in a situation where they need to exit a large position quickly for reasons that have nothing to do with trying to exert influence or control. A change of manager, unexpected poor performance, the need to satisfy shareholder redemptions, or skepticism around the viability of a fund may all lead an acquiring fund to want to redeem greater than 3% of outstanding shares within a 30-day window. We believe rules that limit such redemptions would ultimately impair the ability of fund managers to make prudent decisions that benefit their shareholders. The redemption limit would also have a disproportionate negative affect on smaller funds since fund of funds would likely migrate out of smaller funds into larger funds in order to dilute their position and avoid the impact of the redemption limit.

The Proposal also creates issues for open end funds that are subject to the SEC’s recently finalized liquidity risk management rule (Rule 22e-4). Presumably, any holdings that an open-end fund is prohibited from redeeming under the Proposal would be deemed an illiquid asset under Rule 22e-4, which generally requires funds to hold no more than 15% in illiquid assets. The 3% redemption limit would thus be fundamentally at odds with the goals and impact of Rule 22e-4, providing another reason for the Commission to drop the 3% limit in any final rule.

More troublingly, the Proposal also would apply this redemption limit to funds that are affiliated with one another. Existing rules generally allow funds that are affiliated to freely invest in or redeem shares, so the Proposal would fundamentally change the manner in which affiliated funds operate. Concerns over undue influence or attempts to exert control over an acquired fund do not exist in the context of

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9 Proposal at 28
affiliated funds, so it would make little sense to apply such redemption restrictions to funds that are affiliated with one another.

Other measures contained in the Proposal – such as mirror voting and limiting the ability of funds under a common adviser from “controlling” other funds – offer much more robust protection against the type of undue influence the SEC is concerned about. Accordingly, we believe the SEC should consider altogether dropping the proposed 3% redemption and, at a minimum, not apply such a limit to funds that are affiliated with one another.

3. **The SEC should consider reviewing existing rules to address any regulatory loopholes that allow fund of funds arrangements to be structured for the purpose of evading ownership thresholds under the Investment Company Act of 1940.**

As stated above, certain provisions in the Proposal would aggregate all investments of an advisory group in an acquired fund for purposes of determining control. As the Proposal states, these provisions “would prevent a fund or adviser from circumventing the control condition by investing in an acquired fund through multiple controlled entities…”10 By aggregating all funds within an advisory group and subjecting them to the voting and control limits that would apply under the Proposal, these provisions are intended in part to prevent against abuse of the rules. While the Proposal does not include private funds or foreign funds under the proposed Rule 12d1-4, we believe that this is an ideal time for the SEC to consider other areas where rules regarding ownership thresholds may be circumvented.

For example, the Proposal does not directly address instances where multiple private but related funds are used to obtain a greater than 3% stake in a registered fund (for example a closed end fund) – a stake that would generally be prohibited under existing rules. Under such a scenario, the acquiring fund’s common adviser may then use this aggregated position to threaten proxy contests or other measures in order to create a liquidity event that benefits the acquiring funds in the short term. The liquidity event could involve a large tender offer, or an outright liquidation that ultimately harm the long-term shareholders of the acquired fund. Given the existing concerns that the SEC clearly has over undue influence exerted by acquiring funds and their advisory group, we believe the SEC should also take steps to address any

10 Proposal at 33
regulatory gaps that allow unregistered funds to use multiple entities solely for the purpose of evading ownership thresholds under the 1940 Act.

4. **The SEC should not foreclose the availability of future exemptive relief or no-action requests for fund of funds arrangements and should be mindful not to rescind existing no-action relief not directly impacted by the Proposal.**

   As stated above, the Proposal would rescind many of the longstanding exemptive orders and potentially certain no-action letters that have been issued by the SEC over the years to facilitate certain fund of funds arrangements. While we understand the SEC’s desire to create a uniform fund of funds regulatory framework that does not rely on a patchwork of exemptive orders, we urge the SEC to be thoughtful in rescinding no-action relief and we believe the SEC should explicitly state in any final rule that funds can still seek exemptive relief for particular circumstances going forward. The fund industry is constantly evolving and innovating in order to meet the needs of investors. As its regulator, the SEC should be thoughtful about arrangements it has permitted under existing no-action relief that are not directly impacted by the Proposal, and also open in the future to allowing certain arrangements that may not be envisioned under the current Proposal.

**Conclusion**

We appreciate the Commission putting forth this Proposal, which is part and parcel of the SEC’s ongoing efforts to review and modernize our nation’s securities laws. We look forward to working the commissioners and staff on the Proposal and CCMC recommendations as the SEC moves forward on this initiative.

Sincerely,

[Signature]

Tom Quaadman