



May 2, 2019

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Comments Concerning the Proposed Changes to Fund of Funds Arrangements

File No. S7-27-18

Dear Mr. Fields:

I am writing on behalf of MFS Investment Management ("**MFS**" or "**We**")¹ in response to the invitation by the U.S. Securities and Exchange Commission (the "**Commission**") to provide comments on the Commission's recently proposed changes to the fund of funds regulatory framework.²

We appreciate the opportunity to provide our thoughts on the Proposing Release, including the proposal to adopt new Rule 12d1-4 (the "**Rule**") and rescind existing Rule 12d1-2 and related exemptive relief. MFS has extensive experience managing funds of funds dating back to 1998, and, as of March 31, 2019, managed approximately \$40 billion in assets of MFS sponsored funds of funds that are registered under the Investment Company Act of 1940, as amended (the "**Act**").³ MFS serves as the investment adviser to a variety of funds of funds that invest solely within the same "group of investment companies" as defined under Section 12(d)(1)(G)(ii) (commonly known as "**Affiliated Funds of Funds**"). Such Affiliated Funds of Funds managed by MFS consist of funds of

¹ MFS Investment Management traces its history back to 1924 and the creation of the country's first open-end mutual fund, Massachusetts Investors Trust. Today MFS is a global investment manager managing approximately \$428 billion in assets as of December 31, 2018, through a variety of collective investment vehicles and separate accounts, including approximately \$197 billion managed in registered investment companies for which MFS serves as the primary investment adviser.

² U.S. Securities and Exchange Commission, *Fund of Funds Arrangements*, Investment Company Act Rel. No. 33329 (Dec. 19, 2018), 84 FR 1286 (Feb. 1, 2019), available at <https://www.govinfo.gov/content/pkg/FR-2019-02-01/pdf/2018-27924.pdf> (the "**Proposing Release**").

³ For purposes of this letter, we define a fund of funds as an investment company registered under the Act that invests in other investment companies registered under the Act beyond the limits of Section 12(d)(1)(A), but excluding cash sweep arrangements using money market funds registered under the Act.

funds that (i) invest exclusively in funds, (ii) invest in a combination of funds and non-investment company instrument types, such as stocks, bonds, and derivatives, or (iii) are considered a fund of funds solely due to an investment in a "central" fund. MFS additionally has experience managing underlying funds in funds of funds managed by non-affiliated investment advisers ("**Unaffiliated Funds of Funds**").

We believe that funds of funds serve a vital role in helping retail investors achieve their financial goals through offering a cost-efficient method of providing diversification and asset allocation. We are supportive of the Commission's effort through the Proposing Release to streamline regulatory processes and level the playing field for all industry participants. We do, however, encourage the Commission to consider the comments articulated in this letter and the comment letters submitted on the subject by the Investment Company Institute ("ICI") and the Securities Industry and Financial Markets Association – Asset Management Group ("**SIFMA-AMG**"), both of which we largely agree with.⁴ We believe that by enhancing the proposed regulatory framework set forth in the Proposing Release through implementing the targeted comments discussed in this letter, the Commission can continue to protect investors from the historic abuses involving funds of funds, while supporting the continued growth and evolution of the fund of funds industry.

I. Executive Summary

The following summarizes our comments on the proposed changes included in the Proposing Release:

- ***Affiliated Funds of Funds that cannot rely solely upon Section 12(d)(1)(G) should not be subject to the Rule and Rule 12d1-2 should not be rescinded, but rather enhanced by codifying current exemptive relief.***
- ***Should the Commission elect to subject Affiliated Funds of Funds to the Rule, Affiliated Funds of Funds should be exempt from the Redemption Condition⁵, as an investment adviser's fiduciary duty and board oversight requirements provide sufficient protections to investors.***
- ***Should the Commission elect to subject Affiliated Funds of Funds to the Rule, investments in "central" funds by Affiliated Funds of Funds should not be subject to the Redemption Condition.***
- ***The Commission should consider revising the Redemption Condition to make enforcement optional for underlying funds.***
- ***The use of "central" funds in three-tier funds of funds should be exempt from the general prohibition in the Rule on complex structures.***

⁴ In particular, we encourage the Commission to consider the comments included Section IX of the ICI's comment letter addressing the ability of private funds to exert undue influence on acquired closed end funds due to limitations in Section 12(d)(1)(C).

⁵ As defined in Section III of this letter.

II. Affiliated Funds of Funds that cannot rely solely upon Section 12(d)(1)(G) should not be subject to the Rule and Rule 12d1-2 should not be rescinded, but rather enhanced by codifying current exemptive relief.

As discussed above, MFS serves as the investment adviser to a variety of Affiliated Funds of Funds. Several of these funds rely on a combination of the exemptions contained in Section 12(d)(1)(G), Rule 12d1-2 and an exemptive order granted by the Commission⁶ to invest in underlying funds beyond the limits set by Section 12(d)(1)(A), while preserving the flexibility to invest in certain non-investment company instruments, including stocks, bonds, and derivatives. We believe that this regulatory framework provides a functional structure for Affiliated Funds of Funds to achieve their investment objectives and, therefore, we encourage the Commission to implement enhancements to further streamline this framework rather than to replace it.

We appreciate that one of the Commission's primary goals in the Proposing Release is to simplify and streamline the current fund of funds regulatory framework, much of which has been built on no-action relief and individually tailored exemptive orders. We believe that this goal can still be achieved through maintaining the current regulatory framework for Affiliated Funds of Funds, while adopting the Rule and limiting its application to Unaffiliated Funds of Funds. This approach would establish clearly delineated paths for all types of funds of funds seeking to invest beyond the limits of Section 12(d)(1)(A), and reduce complexity in the current version of the Rule by removing the need to include a specific exemption for Affiliated Funds of Funds from the Rule's voting and control conditions. Furthermore, the Commission should use this opportunity to expand the available instruments permitted under Rule 12d1-2 to include non-security instrument types, such as derivatives, and thereby eliminate the need to preserve the no-action relief⁷ and exemptive orders relied upon by Affiliated Funds of Funds to invest in these instruments. Derivatives and other non-security instruments are important tools for Affiliated Funds of Funds seeking to hedge and manage portfolio risk or to gain exposure to specific issuers or asset classes in a cost efficient manner, and therefore codifying access to these instruments would benefit shareholders by providing investment advisers with a more predictable and sound regulatory basis to employ these strategies.

We believe the above proposed expansion of Rule 12d1-2 is consistent with the scope and purpose of the rulemaking power granted to the Commission under Section 12(d)(1)(J). Specifically, Congress intended the Commission to apply Section 12(d)(1)(J) to "adopt rules and process exemptive applications in a progressive way as the fund of funds concept continues to evolve over time", while considering factors that relate to the protection of investors.⁸ Expanding Rule 12d1-2 to permit Affiliated Funds of Funds to invest in non-security instrument types, such as derivatives, would facilitate the continued evolution of funds of funds by reducing the complexity of the patchwork of exemptive

⁶ Massachusetts Financial Services Company, *et al.*, Investment Company Act Release No. 28694 (April 14, 2009).

⁷ See *Northern Lights Fund Trust*, SEC Staff No-Action Letter (pub. avail. Jun. 29, 2015).

⁸ See H.R. Rep. No. 602, 104th Congr. 2d Sess., at 43-44 (1996).

orders and no-action relief, without introducing any additional risks to shareholders.

III. Should the Commission elect to subject Affiliated Funds of Funds to the Rule, Affiliated Funds of Funds should be exempt from the Redemption Condition, as an investment adviser's fiduciary duty and board oversight requirements provide sufficient protections to investors.

If the Commission determines that it is necessary to adopt a single rule for all funds of funds that cannot rely upon Section 12(d)(1)(F) or Section 12(d)(1)(G), MFS encourages the Commission to exempt Affiliated Funds of Funds from the Rule's condition limiting a top-tier fund from redeeming in excess of 3% of an underlying fund's shares within a 30-day period (the "**Redemption Condition**").⁹ The Commission states in the Proposing Release that the Rule is designed, in part, to facilitate the continued evolution of funds of funds, while imposing conditions that are meant to protect investors from historic abuses involving funds of funds.¹⁰ The Commission specifically points to a number of well-documented abuses, including, but not limited to, a top-tier fund acquiring a sufficiently large position to exert undue influence on an underlying fund (so called "**pyramiding**").¹¹ The Rule includes two separate conditions designed to prevent the occurrence of pyramiding, including (i) the Redemption Condition, and (ii) a condition limiting a top-tier fund from acquiring a controlling position in an underlying fund (generally defined as 25% of an underlying fund's shares) and requiring that a top-tier fund utilize "mirror" or "pass-thru" voting for holdings exceeding 3% of an underlying fund's shares (collectively, the "**Control Condition**").

The Commission has elected to exempt Affiliated Funds of Funds relying on the Rule from the Control Condition, citing the existence of a common fiduciary duty owed by an investment adviser to both the top-tier and underlying fund. This fiduciary duty requires an investment adviser to act in the best interest¹² of both funds and, therefore, serves to mitigate the risk of undue influence resulting from a top-tier fund's ownership concentration and voting control. The Commission, however, neglects to apply this same reasoning with respect to the Redemption Condition. In fact, the Commission indicates that maintaining the Redemption Condition further supports exempting Affiliated Funds of Funds from the Control Condition, by providing an additional check on the ability of a top-

⁹ Apart from the comments concerning the Redemption Condition articulated in this letter, we note that in the Proposing Release, the Commission indicates that an exemption from Section 22(e) of the Act is not required in connection with the Redemption Condition, because the top-tier fund's ability to make a redemption request is being restricted, as opposed to the underlying fund's obligation to honor such request. See Proposing Release, 84 FR at 1298 note 115. We believe that this position is arguably inconsistent with Commission precedent. For example, Rule 6c-7 under the Act provides an exemption from Section 22(e) for registered separate accounts offering variable annuity contracts to participants in the Texas Optional Retirement Program ("Program"), even though it is the Program participant's ability to make a redemption request that is being restricted, as opposed to the separate account's obligation to honor such a request.

¹⁰ See Proposing Release, 84 FR at 1290.

¹¹ See *id.* at 1287.

¹² SEC v. Capital Gains, 375 U.S. 180, 191 (1963).

tier fund to exert undue influence.¹³ We respectfully disagree with this position and note that each of the voting, control, and redemption conditions seek to address unique ways in which a top-tier fund can exert undue influence on an underlying fund. However, we believe that the common fiduciary duty of an investment adviser to all tiers of an Affiliated Fund of Funds mitigates the risk of all potential channels through which a top-tier fund may exert undue influence on an underlying fund. Furthermore, in the event that an investment adviser to an Affiliated Fund of Funds breaches its fiduciary duty to an underlying fund to benefit a top-tier fund, Section 36(a) provides the Commission with a mechanism to hold the investment adviser accountable and seek remedy.¹⁴

Additionally, many mutual fund complexes, including the MFS funds, have a common board of directors/trustees that provide oversight to all funds in the complex. It is well established that the independent directors/trustees of a mutual fund board serve a particularly important function as the "independent watchdog" of shareholders and provide an independent check on a fund's investment adviser with an eye towards monitoring conflicts of interest.¹⁵ We believe that the presence of a common independent board overseeing all tiers of an Affiliated Fund of Funds serves as a very significant layer of oversight, and coupled with an investment adviser's common fiduciary duty, eliminates the need to subject Affiliated Funds of Funds to the Redemption Condition.

We also note that the flexibility that Rule 12d1-2 and the exemptive orders and no-action letters provide to Affiliated Funds of Funds to invest in non-investment company instruments¹⁶ enables such Affiliated Funds of Funds to diversify their asset base beyond what is permissible to a fund of funds relying solely on Section 12(d)(1)(G). One consequence of this diversified asset base is that such Affiliated Funds of Funds will have less of an ability to exert undue influence on an underlying fund than one that does not invest its assets in other instruments. Therefore, if the Rule is adopted, funds of funds that pose less of a risk of exercising undue influence will be subject to greater constraints than funds of funds that pose a greater risk of exercising undue influence by virtue of the limited nature of their holdings.

Finally, we believe that imposing the Redemption Condition on Affiliated Funds of Funds would result in the following unintended consequences, which could negatively impact shareholders of top-tier funds:

¹³ Proposing Release, 84 FR at 1297, stating: "We [the Commission] believe that the proposed rule's other conditions, such as the redemption condition... would mitigate against the risks of undue influence when the arrangements involve funds that have advisers that are control affiliates."

¹⁴ Section 36(a) authorizes the Commission to bring an action against a person serving in a number of capacities with respect to a registered investment company, including an investment adviser, for any act or practice constituting a breach of fiduciary duty.

¹⁵ *Burks v. Lasker*, 441 U.S. 471, 484 (1979).

¹⁶ We note that Affiliated Funds of Funds relying on Section 12(d)(1)(G) are also permitted to invest in government securities and short-term paper.

- To avoid the Redemption Condition, Affiliated Funds of Funds will sacrifice the flexibility to invest in non-investment company instruments (such as stocks, bonds, and derivatives) and instead opt to rely on Section 12(d)(1)(G). Consequently, such Affiliated Funds of Funds will lose the ability to employ a variety of strategies to efficiently reduce portfolio risk, such as using derivatives to hedge against currency or interest rate fluctuations. For example, an Affiliated Fund of Funds that employs an international focused investment strategy would lose the ability to utilize important safeguards, such as hedging currency risk using currency forwards or swaps, to react to destabilizing global events, such as recent episodes of volatility in the British Pound Sterling experienced as a result of the United Kingdom's decision to leave the European Union ("Brexit").¹⁷
- Affiliated Funds of Funds that elect to maintain the flexibility to invest in non-investment company instruments will favor investing in larger underlying funds or exchange traded funds¹⁸ to avoid triggering the limitations of the Redemption Condition. As such, smaller funds and non-exchange traded funds will be less attractive targets for funds of funds, which ultimately harms shareholders by limiting an investment adviser's available investment universe and potentially hindering new product innovation.¹⁹ Additionally, this could create a scenario in which an investment adviser is conflicted in discharging its fiduciary duty to shareholders. For instance, an investment adviser may determine it is in the best interest of shareholders to preserve a fund's liquidity and investment flexibility and thereby limit the fund's investment in smaller funds, particularly specialized funds, ultimately depriving shareholders of those beneficial and diversifying exposures.

IV. Should the Commission elect to subject Affiliated Funds of Funds to the Rule, investments in "central funds" by Affiliated Funds of Funds should not be subject to the Redemption Condition.

As discussed above, we do not believe that Affiliated Funds of Funds that invest in non-investment company instruments should be subject to the Rule. However, if the Commission elects to subject such Affiliated Funds of Funds to the Rule, including the Redemption Condition, the Commission should exempt investments in "central funds" from the Redemption Condition. Central funds, which are typically organized as open-

¹⁷ See <https://www.wsj.com/articles/companies-prepare-for-currency- gyrations-amid-brex-it-turmoil-1542308240>.

¹⁸ See Proposing Release, 84 FR at 1299, providing that funds listed on an exchange may continue to be sold without regard to the 30-day volume limit.

¹⁹ We also note recent statements by the Staff prioritizing the examination of barriers, including regulatory barriers, that make it harder for small and mid-sized asset managers to compete with larger industry participants. See <https://www.sec.gov/news/speech/speech-blass-031819>.

end funds that are registered under the Act, are an important tool to gain exposure to specific asset classes that may be inefficient or costly to purchase directly, such as high yield fixed income instruments. These funds operate by pooling resources of top-tier funds to (i) achieve economies of scale in acquiring positions, (ii) reduce trading costs and cash drag by netting flow activity, (iii) and increase diversification. Central funds are generally available only to funds within the same fund complex and do not charge distribution or management fees. As central funds are designed to serve as a proxy for entire asset classes, funds that utilize central funds typically invest beyond the limits of Section 12(d)(1)(A), while also holding non-investment company instruments and, therefore, such funds would be subject to the Rule.²⁰

We believe that subjecting Affiliated Funds of Funds that invest in central funds and non-investment company instruments to the Redemption Condition would be very disruptive to the management of these funds and potentially negate the benefits of using such structures. For example, MFS currently manages a central fund that invests in high yield fixed income instruments, which is utilized by MFS managed top-tier funds to efficiently gain access to this asset class. One of these top-tier funds holds, as March 31, 2019, approximately 74% of the shares of this central fund, and since January 1, 2016, has redeemed more than 3% of the central fund's shares in 9 months (25% of the months surveyed).²¹ If the Rule is adopted as proposed, these 9 months of redemptions over 3% represent instances where the top-tier fund's investment staff would be limited in freeing up assets to strategically reallocate the top-tier fund's investments or potentially meet redemption requests. To avoid the above scenario, we believe that investment advisers would opt to invest directly in underlying instruments as opposed to using central funds, which would result in depriving shareholders of the efficiency and cost-savings generated by central funds. Finally, as noted above, central funds are generally held only by Affiliated Funds of Funds that are subject to a common fiduciary duty, which mitigates the risk of historic abuses, such as pyramiding.²²

V. The Commission should consider revising the Redemption Condition to make enforcement optional for underlying funds.

If the Commission determines to retain the Redemption Condition in the final version of the Rule, we encourage the Commission to enhance this condition by adopting the approach set forth under Section 12(d)(1)(F)(ii), which establishes a similar redemption

²⁰ For example, a total return bond fund that invests in fixed income instruments of various credit quality, may invest in an affiliated central fund beyond the limits set by Section 12(d)(1)(A) to more efficiently gain exposure to high yield fixed income instruments, while investing the remainder of the portfolio directly in investment grade bonds. Under the current regulatory framework, this fund would need to rely on the exemptions provided under Sections 12(d)(1)(G) and Rule 12d1-2 to implement this structure and would be subject to the Rule, if it were adopted as proposed.

²¹ For purposes of this illustration we have used calendar month as a proxy for the 30-day redemption period under the Redemption Condition.

²² Ownership by only affiliated top-tier funds could be codified in the Rule in order for a central fund to be exempt from the Redemption Condition.

limit but provides the underlying fund discretion to not enforce the limit.²³ In the Proposing Release, the Commission acknowledges this flexibility provided under Section 12(d)(1)(F)(ii), but concludes that a mandatory redemption limit is necessary under the Rule to prevent a top-tier fund from influencing an underlying fund's decision to forgo enforcing the redemption limit.²⁴ We are not aware of any instances where this type of undue influence has been asserted by a top-tier fund relying on Section 12(d)(1)(F). We do, however, believe that making enforcement of the Redemption Condition optional for an underlying fund would allow each underlying fund to assess the potential threat of undue influence and implement its own tailored approach based on its unique facts and circumstances. Under this scenario, an underlying fund could assess its liquidity needs as well as the concentration and nature of any top-tier fund holding its shares when determining whether or not to enforce the Redemption Condition.

VI. The use of "central" funds in three-tier funds of funds should be exempt from the general prohibition in the Rule on complex structures.

The Proposing Release seeks to limit the proliferation of complex multi-tier funds of funds by including a general prohibition on three-tier funds of funds, with certain narrow exceptions. Specifically, the Rule prohibits a fund of funds relying on the Rule or Section 12(d)(1)(G) from acquiring shares of an underlying fund beyond the limits set by Section 12(d)(1)(A), where such underlying fund is itself a top-tier fund relying on the Rule. While we appreciate the Commission's goal of curbing overly complex funds of funds, we encourage the Commission to consider exempting three-tier funds of funds from this prohibition where the third-tier fund is a central fund.

The Rule, as proposed, exempts three-tier funds of funds from the prohibition on complex multi-tier funds where the underlying fund of funds invests in a wholly-owned investment vehicle to more efficiently gain exposure to certain investments.²⁵ We believe that funds of funds relying on the Rule to invest in central funds should be viewed similarly and should be included within the exception, as such structures are used exclusively to achieve investment efficiencies and create cost savings for shareholders. Central funds, while not structured as wholly-owned investment vehicles, are generally limited to a discrete group of top-tier funds. Additionally, as noted in Section IV, central funds do not charge distribution or management fees, mitigating the risk of fee layering. Finally, we believe that any complexity resulting from a three-tier fund of funds utilizing a central fund would be justified by the realized cost savings passed along to shareholders.

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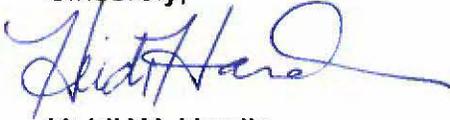
²³ Section 12(d)(1)(F)(ii) provides that an underlying fund is not obligated to (but has the option to) redeem more than 1% of its outstanding shares to a top-tier fund during any 30-day period.

²⁴ Proposing Release, 84 FR at 1300, stating: "An acquiring fund, however, could influence an acquired fund to eliminate (or never establish) a limit on redemptions if the redemption condition were merely permissive. We [the Commission] therefore propose a mandatory limit on submitting redemptions as a more effective means to mitigate the threat of undue influence than an optional limit."

²⁵ See Proposing Release, 84 FR at 1308, citing an example of a fund investing in a wholly-owned Cayman Island-domiciled company in order to gain exposure to commodity-related instruments for tax and other reasons.

We appreciate the opportunity to provide comments on the Proposing Release. If you have any questions, please contact me at [REDACTED] or Chris Bohane at [REDACTED].

Sincerely,



Heidi W. Hardin

cc:

The Honorable Jay Clayton
Chairman
U.S. Securities and Exchange Commission

The Honorable Robert J. Jackson, Jr.
Commissioner
U.S. Securities and Exchange Commission

The Honorable Hester M. Peirce
Commissioner
U.S. Securities and Exchange Commission

The Honorable Elad L. Roisman
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