Consumer Federation of America

May 2, 2019

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

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

Dear Acting Secretary Countryman:

I am writing on behalf of the Consumer Federation of America (CFA)[1] in response to the Commission's proposed rule on fund of funds arrangements.[2] While the Commission's goal of formalizing a more consistent and streamlined approval process for funds to invest in other funds beyond the limits of section 12(d)(1) of the Investment Company Act is commendable, we are concerned that the proposal, as currently drafted, would not provide sufficient protections for investors and it may expose them to greater risks than they face under the existing regulatory framework.

Specifically, we fear that the proposed regulatory approach would open the door to new types of fund of funds arrangements that have excessive costs, poor performance, and overly complex structures. We also question the proposed redemption limit, which could lock fund of funds investors into investments that no longer serve their best interests for unreasonable amounts of time. In addition, the requirements for an acquiring fund's adviser to make certain findings to invest in an acquired fund are insufficient to protect investors from excessive fees and overly complex structures. And we are not confident that existing fiduciary requirements, at least as interpreted and enforced by the Commission and enforced by private investors, provide sufficient protections against these risks. Finally, the economic analysis is weak and incomplete, and it's clear the Commission does not adequately understand the impacts that the proposed rule would likely have.

However, there are some positive aspects of the proposal. We agree with the Commission that applying the control conditions to an acquiring fund and its advisory group, rather than limiting their applicability to the acquiring fund alone, is appropriate. We also strongly support the restriction on multi-tier structures.

---

[1] The Consumer Federation of America is a non-profit association of nearly 300 consumer groups that was established in 1968 to advance the consumer interest through research, advocacy, and education.
[2] Fund of Funds Proposing Release, Investment Company Act Release No. 33329 (December 19, 2018) https://bit.ly/2VehcXZ.

In sum, this proposal is extraordinarily complex and it could have a multitude of unintended consequences, as a result of which we're not convinced the proposed rule would leave investors and market participants better off than they are under the existing individual exemption process for creating regulatory compliant fund of funds arrangements. The Commission has not provided sufficient analysis in this regard, which is this proposal's most serious flaw. If the Commission moves forward with this proposal, it must do a better job to ensure that this rulemaking would improve outcomes, particularly for unsophisticated retail investors, who are the primary beneficiaries of – and who have the most to lose from harmful – fund of funds arrangements.

Background

Fund of funds arrangements can be very beneficial for retail investors, particularly those with modest assets who cannot readily create a diversified portfolio on their own. Fund of funds can provide these investors with diversified exposure to different asset classes and strategies through a single, professionally managed portfolio.[3] Purchasing one professionally managed fund can be simpler and less expensive than purchasing multiple funds individually and monitoring and rebalancing the portfolio over time, which makes them a great option for many retail investors.[4]

The fund of funds market is large and growing. According to the Investment Company Institute's (ICI's) 2018 Fact Book, the total net assets of open-end funds of funds increased from $638 billion at the end of 2007 to over $2.2 trillion at the end of 2017, and the total net assets of exchange-traded fund (ETF) funds of funds increased from $97 million at the end of 2008 to just under $12 billion at the end of 2017.[5] As the total net assets of funds of funds have increased, so have the number of funds of funds. At the end of 2007, there were 704 open-end mutual funds that invested primarily in other mutual funds, and that number grew to 1,400 at the end of 2017.[6] In total, there are over 4,300 acquiring funds, including open-end mutual funds, unit investment trusts (UITs), ETFs, and closed-end funds, that invest in other funds.[7]

Target date funds and other lifestyle funds are common types of fund of funds arrangements that are marketed and sold predominantly to unsophisticated retail investors. Target date funds pair an appropriate asset allocation strategy to an investor's time until retirement. Target date funds shift their asset allocations and risk exposures over time according to a glide path that first seeks to grow investors' money during the accumulation phase, then dials down the risk when the investor nears and enters retirement.[8] Given that they are advertised and function as "set-it-and-forget-it" investments, funds of funds such as target date funds and other lifestyle funds are by their nature likely to attract less-sophisticated investors who do not want to engage in active portfolio management and instead are looking for a hands-off approach

---

[3] Release at 127.
[4] *Id*. at 7.
[5] Release at 103, citing Investment Company Institute, 2018 Investment Company Fact Book, at 256, https://bit.ly/2NRBXlf; Release at 218.
[6] *Id*.
[7] Release at 102.
[8] Capital Group, American Funds, Retirement Planning, What is a Target Date Fund's Glide Path, https://bit.ly/2ITM61h; T. Rowe Price, Target Date Funds, https://trowe.com/2vyN9uY.

to investing.[9] Similar to the fund of funds market as a whole, target date funds have experienced significant growth in recent years, in large part due to the fact that employers typically include them as the default investment option in company sponsored retirement plans.[10] According to Morningstar's 2018 Target-Date Fund Landscape report, assets in target date mutual funds grew from $158 billion at the end of 2008 to over $1 trillion in 2017.[11] That amounts to more than $40 billion in net flows each year since 2008.[12]

While fund of funds arrangements can provide significant benefits to retail investors, funds of funds can also engage in activities that are detrimental to retail investors. First, when a fund invests in other funds within its fund family, conflicts of interest arise. Academic research has found, for example, that some target date funds use constituent funds from the same fund family that have high expense ratios or poor performance.[13] According to this research, these funds may choose to include funds with high expense ratios in order to increase revenues to the family, and they may use funds with poor performance and/or low flows to sustain funds that may be less marketable.[14] Other academic research finds that funds of funds may offset severe liquidity shortfalls that are experienced by other funds in their fund family.[15] According to this research, offsetting severe liquidity shortfalls benefits the fund receiving the liquidity because it enables them to avoid engaging in fire sales. It also benefits the fund family because it preserves the family's overall value. On the other hand, it reduces the fund of funds' own investment performance and, as a result, the fund of funds' investors ultimately bear the cost.[16]

Second, when a fund invests in other funds outside the same fund family, it can create the opportunity for "pyramiding," a practice in which an acquiring fund exerts control, directly through voting or indirectly through the threat of large-scale redemptions, over an acquired fund, which could be detrimental to the acquired fund's shareholders.

Fund of funds arrangements can create other problems for investors regardless of whether the acquired funds are part of the same fund family or are unrelated to the acquiring fund. These

---

[9] Capital Group, What is a Target Date Fund's Glide Path ("Target date funds are a convenient choice for investors who want professional management for their retirement assets in a single, easy-to-use investment."); T. Rowe. Price, Target Date Funds ("Achieve a diversified investment portfolio -- in one easy step"); Scott J. Donaldson, et al., Vanguard's approach to target-date funds, Vanguard, March 2019, https://vgi.vg/2UUJ8vd ("Research indicates that many investors lack time for or interest in retirement planning. Target-date funds (TDFs) are designed to help them build a professionally diversified portfolio and achieve their retirement goals."); Michael Anthony Solari, *Everything you need to know about target-date funds*, CNBC.COM, June 4, 2018, https://cnb.cx/2LYZGi7.

[10] Building Financial Futures, Trends and Insights of those saving for retirement across America, Fidelity, 2018, https://bit.ly/2IUnMfV (based on Fidelity's analysis of 22,600 corporate DC plans, 98% of employers offered target date funds and 89% used them as the default investment option).

[11] Jeff Holt and Heather Larsen, 2018 Target-Date Fund Landscape, Sizing Up the Trillion Dollar, Increasingly Passive Giant, Morningstar, May 7, 2108, https://Bit.Ly/2grjdwp.

[12] *Id*.

[13] Vallapuzha V. Sandhya, Agency Problems in Target-Date Funds, Georgia State University Working Paper (2010), https://bit.ly/2UUMcrd.

[14] *Id*. at 2.

[15] Utpal Bhattacharya, Jung H. Lee, & Veronika K. Pool, Conflicting Family Values in Mutual Fund Families, 68 J. of Fin. 173 (2013) https://bit.ly/2WoQf0w.

[16] *Id*. *See also* Judith Chevalier and Glenn Ellison, Risk taking by mutual funds as a response to incentives, Journal of Political Economy 105, 1167–1200 (1997) https://bit.ly/2VIV4o7 (arguing that the fund family's aim is to maximize the value of the complex, rather than that of an individual fund).

include charging excessive fees, which can reduce investors' returns, and forming overly complex structures, which can confuse investors. Specifically, because funds of funds have multiple layers of investments, this can create the opportunity to charge multiple levels of fees for duplicative services. It can also create an opportunity to invest in higher-cost underlying funds than is necessary. And because multiple layers of investments can make it difficult for investors to understand what they are investing in, they can increase the risk that investors will be pay excessive fees and suffer reduced returns. Complexity and opacity are often associated with excessive fees in the investment industry.

Section 12(d)(1) of the Investment Company Act limits the ability of a fund to invest substantially in shares of another fund. Congress enacted these restrictions because it was concerned about the potential for acquiring funds to exert control or undue influence over acquired funds, charge excessive or duplicative fees, and form overly complex structures that could be confusing to investors.

Congress subsequently created statutory exceptions that permit different types of fund of funds arrangements. Included in these statutory exceptions is section 12(d)(1)(G), which allows a registered open-end fund or UIT to invest in other open-end funds and UITs that are in the same "group of investment companies," defined as any two or more registered funds that hold themselves out to investors as related companies for purposes of investment and investor services. When Congress enacted section 12(d)(1)(G), it also gave the Commission specific authority to permit additional types of fund of funds arrangements as structures evolved. For close to two decades, the Commission has used the individual exemptive process to permit additional types of fund of funds arrangements.

The proposed rule seeks to replace the existing process of obtaining individual exemptive orders for fund of funds arrangements. According to the proposing Release, the Commission is seeking to formalize a consistent and streamlined approval process for fund of funds arrangements on the grounds that the existing individual exemptive process can be expensive for funds to undertake, result in delays to bring funds to market, subject funds and the market to uncertainty, and result in potentially inconsistent conditions for substantially similar funds.

However, the statutory exceptions would continue to be available and would provide alternative bases for creating funds of funds. As a result, the proposal would not address the conflict of interest problem when a fund invests in other funds within its fund family. Nor would it address the situation where a fund invests in other funds within its fund family that have higher costs than are necessary, layers fees for duplicative services provided by other funds within its fund family, or forms overly complex structures that are confusing to investors by using other funds within its fund family. While we understand that the Commission's ability to address these issues in the context of this rulemaking is limited, the Commission is not limited from using its enforcement authority to ensure that fund of funds advisers and their boards of directors comply with their fiduciary duties and, in so doing, meaningfully serve the best interest of their funds and their funds' investors. We urge the Commission to step up its enforcement in this regard as its current approach to enforcement has been insufficient to address these problems.

Our comments as they relate to the nature and scope of this rulemaking are discussed in greater detail below.

I. The proposed rule would expand the scope of permissible acquiring and acquired funds, opening the door to new types of fund of funds arrangements that could expose investors to excessive costs and poor performance and other risks associated with overly complex structures. The Commission has proposed this expansion without any serious analysis of what would result from such a sweeping change or explanation of why it would be in investors' best interest.

Under existing exemptive orders, fund of funds arrangements are generally limited in the types of investments they can make. For example, open-end funds cannot invest in closed-end funds or business development companies (BDCs) that are not listed and traded on a national securities exchange.[17] In addition, closed-end funds may not invest in other closed-end funds, listed or unlisted.[18] According to the Commission's economic analysis, most funds of funds that exist today involve a structure where the acquiring fund is an open-end fund.[19] However, the proposal would allow closed-end funds and BDCs, including those that are listed and unlisted, to invest in other closed-end funds, including those that are listed and unlisted.[20]

The Commission justifies this significant expansion on the grounds that it would provide funds covered by the rule with "flexibility to meet their investment objectives" and that the rule's scope would "eliminate unnecessary and potentially confusing distinctions among permissible investments for different types of acquiring funds."[21] Further, the proposed rule would "level the playing field among these entities, allowing each to invest in the same universe of acquired funds in excess of the limits in section 12(d)(1) without obtaining individualized exemptive relief from the Commission," according to the Release.[22]

But that justification ignores the fact that both Congress and the Commission have long treated open-end funds differently from closed-end funds, and BDCs in particular differently from other investment companies. For example, Section 12(d)(1)(C) specifically limits fund investments in closed-end funds and Section 12(d)(1)(G) provides relief only to open-end funds and UITs.[23] The Commission cannot reasonably lift these restrictions without a more thorough and substantive discussion than it has provided here of why those restrictions are no longer needed or justified.

Moreover, this expansion would represent an about face from very recent exemptive orders, which included representations that acquiring funds would not invest in reliance on the order in closed-end funds or BDCs that are not listed and traded on a national securities

[17] Release at 15-17.
[18] *Id*.
[19] *Id*. at 101.
[20] *Id*. at 16.
[21] *Id*. at 16-17.
[22] *Id*. at 17.
[23] 15 U.S.C. § 80a-12(d)(1)(C), (G).

exchange.[24] Ostensibly, there is a reason that acquiring funds were not permitted to invest in these securities, yet the Commission has made no effort to understand why or assess the risks to investors that these securities would create if they were permitted in fund of funds arrangements, as they are under the proposed rule. This omission is all the more troubling, given the Commission's lack of experience with BDCs in the funds of funds context. According to the Commission's economic analysis, for example, as of June 2018, of the 4,342 acquiring funds, *none* of the acquiring funds were BDCs, and *only 1%* of the acquired funds were BDCs.[25]

The Commission must not ignore the risks that BDCs and closed-end funds, particularly those that are unlisted, present to investors. As University of Mississippi Professor of Law Mercer Bullard detailed in recent testimony before the House of Representatives Financial Services Committee, the BDC market is characterized by extremely high fees.[26] For example, the BDC registration statements that Professor Bullard reviewed show expense ratios consistently above 5.00 percent and, in some instances, significantly higher. In preparing this letter, we also collected several examples and confirmed that expense ratios for these investments are often exorbitant.

Example 1:

Stockholder transaction expenses (as a percentage of offering price):	
Sales load	3.00%(1)
Offering expenses	1.71%(2)
Dividend reinvestment plan expenses	None(3)
Total stockholder transaction expenses	4.71%
Annual expenses (as a percentage of net assets attributable to common stock):	
Base management fee	2.72%(4)
Incentive fees payable under the Investment Management Agreement (20% of investment income and capital gains)	2.28%(5)
Interest payments on borrowed funds	2.27%(6)
Other expenses	1.40%(7)
Acquired fund fees and expenses	1.30%(8)
Total annual expenses	9.97%

27

Example 2:

Stockholder transaction expenses (as a percentage of offering price):	
Sales load	6.00%(1)
Sales load paid by Investment Adviser	(3.00)%(2)
Offering expenses	2.12%(3)
Offering expenses paid by Investment Adviser	(1.06)%(4)
Dividend reinvestment plan expenses	0.00%(5)
Total stockholder transaction expenses	**4.06%**
Estimated annual expenses (as a percentage of net assets attributable to common stock): (6)	
Base management fee payable under the Investment Advisory Agreement	2.72%(7)
Incentive fee payable under the Investment Advisory Agreement (20.0% of pre-incentive fee net investment income and capital gains)	2.36%(8)
Interest payments on borrowed funds	2.67%(9)
Other expenses	0.94%(10)(12)
Acquired fund fees and expenses	1.54%(11)
Total annual expenses	**10.23%(12)**

28

[24] Release at 15, footnote 33, citing Innovator ETFs Trust, et al., Investment Company Act Release Nos. 33214 (Aug. 24, 2018).
[25] *Id*. at 101.
[26] Testimony of Mercer E. Bullard, President and Founder, Fund Democracy, Inc. and Butler Snow Lecturer and Professor of Law, University of Mississippi School of Law, before the Subcommittee on Capital Markets, Securities and Investment Committee on Financial Services United States House of Representatives, "Legislative Proposals to Improve Small Businesses' and Communities' Access to Capital," November 3, 2017, https://bit.ly/2LwYKWn.
[27] Goldman Sachs BDC, Inc., Prospectus Supplement Filed Pursuant to Rule 497, January 19, 2017, https://bit.ly/2IVAOK5.
[28] TCG BDC, Inc., Form N-2, May 31, 2017, https://bit.ly/2DJPaJg.

We found a BDC ETF with an expense ratio that is nothing short of astronomical.

Example 3:

Annual Fund Operating Expenses
(expenses that you pay each year as a percentage of the value of your investment)

Management Fee	0.40%
Other Expenses	0.09%
Acquired Fund Fees and Expenses[a]	9.00%
Total Annual Fund Operating Expenses[b]	9.49%
Fee Waivers and Expense Reimbursement[b]	-0.08%
Total Annual Fund Operating Expenses After Fee Waiver and Expense Reimbursement[b]	9.41%

[29]

We also found an interval fund (unlisted closed-end fund) with significant expenses.

Example 4:

SUMMARY OF FEES AND EXPENSES

The following table illustrates the aggregate fees and expenses that the Fund expects to incur and that holders of Shares can expect to bear directly or indirectly, including the Fund's annual use of leverage assuming the Fund borrows 10% of its average net assets during the following twelve months.

Shareholder Fees	Class A	Class I	Class L	Class M	Class T
Maximum Sales Load Imposed on Purchases (as a percentage of offering price)	5.75%	None	3.50%	None	3.50%
Annual Fund Expenses					
(as a percentage of average net assets attributable to Shares)[1]					
Management Fee[2]	1.76%	1.76%	1.76%	1.76%	1.76%
Interest Payments on Borrowed Funds[3]	0.35%	0.35%	0.35%	0.35%	0.35%
Other Expenses					
Shareholder Servicing Fee[4]	0.25%	None	0.25%	None	0.25%
Distribution Fee[4]	None	None	0.25%	0.25%	0.25%
Remaining Other Expenses[5]	0.30%	0.30%	0.30%	0.30%	0.30%
Total Annual Fund Operating Expenses	2.66%	2.41%	2.91%	2.66%	2.91%
Fee waiver and/or Expense Reimbursement	(0.05)%	(0.05)%	(0.05)%	(0.05)%	(0.05)%
Total Annual Fund Operating Expenses (after fee waiver and/or expense reimbursement)[6]	2.61%	2.36%	2.86%	2.61%	2.86%

[30]

[29] VanEck Vectors BDC Income ETF (BIZD) https://bit.ly/2GQp206.
[30] FS Credit Income Fund, Prospectus, February 28, 2019, https://bit.ly/2VcaOjS.

With expenses like those that are shown above, it's not clear how an investor would ever be able to earn a decent return. Moreover, these examples offer clear proof that we cannot rely on funds' investment advisers and boards of directors to protect investors' interests. The investment advisers and boards of directors to these investment companies are fiduciaries. Given the fees they are extracting and the costs they are imposing, both direct and indirect, on investors, it's hard to see how these advisers and boards are faithfully fulfilling their fiduciary duties. Yet we are unaware of any recent enforcement actions the Commission has taken against BDCs or closed-end funds for violating their fiduciary duties.

Opening these investments up to more fund of funds investors would increase the risk that investors would be saddled with these high-cost, potentially damaging investments. We wonder where the limit is. Would the Commission allow fund of funds arrangements that include non-transparent ETFs or even worse, non-transparent ETFs holding other non-transparent ETFs? The Release fails to establish any such limits.

It is one thing for the Commission to formalize existing exemptive orders to streamline them and make them more consistent. But it is quite another to significantly expand the scope of relief to areas where the Commission has never previously provided relief and where it has no real experience. If the Commission is going to expand the scope of relief, as it proposes to do here, at the very least, it has a responsibility to seriously analyze the risks to investors of doing so. It has not done so in this Release.

To be clear, we are not opposed, as a matter of principle, to allowing a broader set of investments in fund of funds arrangements. So long as the substantive investor protections are strong enough and are enforced faithfully, then those protections would curb any potential abuses of investors. But, as discussed below, we are not persuaded that the proposal provides those substantive protections and, as discussed above and below, the Commission has not done the bare minimum amount of analysis necessary to make this sweeping change.

II. The proposed requirements to prevent acquiring funds from exercising control or undue influence over acquired funds include both pro-investor and anti-investor provisions.

In order to prevent acquiring funds from exercising control or undue influence over acquired funds, existing exemptive orders for fund of funds arrangements require that, when an acquiring fund and its advisory group hold more than 3% of an acquired fund's outstanding voting securities, the acquiring and acquired funds execute participation agreements that state that the funds understand and agree to comply with the terms and conditions of the order. This requirement allows acquired funds to block the acquisition of their shares by acquiring funds that could exercise control or undue influence over them by refusing to enter into a participation agreement with those funds.

Under the proposal, however, acquiring funds that hold more than 3% of an acquired fund's outstanding voting securities would not be required to execute participation agreements with the funds that they acquire. Instead, the proposed rule would require that an acquiring fund and its advisory group use pass-through or mirror voting to partially mitigate the risk that an

acquiring fund and its advisory group may use its ownership stake to control the acquired fund. In addition, the proposed rule would limit the acquiring fund's ability to quickly redeem acquired fund shares to address concerns that an acquiring fund could threaten to engage in large-scale redemptions as a means of exercising undue influence over an acquired fund. Specifically, the proposal would prohibit an acquiring fund that acquires more than 3% of an acquired fund's outstanding shares from redeeming or submitting for redemption, or tendering for repurchase, more than 3% of an acquired fund's total outstanding shares in any 30-day period.

A. Applying the control conditions to an acquiring fund and its advisory group, rather than limiting their applicability to the acquiring fund alone, is appropriate.

Given the evidence, discussed above, that fund families have incentives to, and in some cases do, act in ways that serve the fund family's interests, it is possible that through combined ownership, a fund family could exercise coordinated control or undue influence over an acquiring fund. To mitigate this risk, it's critical that the 3% threshold apply beyond the individual acquiring fund so that it covers the entire fund family. We therefore support the Commission's decision to apply the 3% threshold to an acquiring fund and its advisory group, rather than limiting their applicability to the acquiring fund alone.

B. The proposed redemption limit would inappropriately lock fund of funds investors into investments that no longer serve their best interests for unreasonable amounts of time, and would raise other thorny issues that are likely to adversely affect fund of funds practices and fund of funds investors.

We are concerned, however, that the redemption limit would have unintended consequences, to fund of funds investors' and funds' detriment. First, it would effectively lock up significant amounts of investors' money in acquired investments for unreasonable amounts of time. If, for example, an acquiring fund's adviser determines that one of its acquired funds is no longer in the best interest of the acquiring fund and its shareholders, the acquiring fund would not be able to quickly liquidate that acquired fund. Rather, it would only be able to redeem 3% of the acquired fund's shares every 30 days. If an acquiring fund and its advisory group owns up to 25% of an acquired fund (the control limit), it would take 10 months to fully unwind its investment in the acquired fund.[31] This would force the acquiring fund and its shareholders to hold onto shares for significantly longer than we believe is reasonable. The result could be that funds of funds and their investors could be forced to hold underlying funds that underperform, have higher costs than alternatives that become available, or that no longer achieve the fund's strategy.

In addition, the redemption limit would raise other complications for funds, particularly with regard to their liquidity risk management programs. According to the Commission's liquidity rules, a fund is not permitted to purchase additional illiquid investments if more than 15 percent of its net assets are illiquid investments that are assets.[32] An illiquid investment is an

[31] Release at 137-138.

[32] Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32315 (Oct. 13, 2016).

investment that the fund reasonably expects cannot be sold in current market conditions in seven calendar days without significantly changing the market value of the investment.[33] Thus, if funds are forced to hold other funds for more than 30 days, it appears that they would need to reclassify those funds as illiquid. Despite the potentially significant impact the interaction of these rules could have, the Commission glosses over this issue in a lone footnote, stating, "An acquiring fund that holds more than 3% of an acquired fund's total outstanding shares should take this limitation into account when classifying this portfolio investment as part of its liquidity risk management program…"[34] Moreover, a fund could hold what are deemed "illiquid" securities despite the fact that, in any other context, the same securities would be viewed objectively as being highly liquid. Surely, this complex issue deserves more attention than the Commission has given it.

Moreover, despite the fact that the Commission has attempted to justify expanding the scope of permissible investments in this rulemaking on the basis that it would "eliminate unnecessary and potentially confusing distinctions among permissible investments for different types of acquiring funds," and "level the playing field among these entities," the redemption limit would apply inconsistently, depending on an acquired fund's structure. Specifically, the proposal makes clear that acquiring funds that invest in acquired funds that are *not* exchange-listed would be subject to the redemption limit.[35] However, acquiring funds that invest in acquired funds that *are* exchange-listed would be permitted to continue to sell shares in the secondary market without regard to the redemption limit, as secondary market transactions would not involve "redemptions" from the acquired fund.[36]

Thus, acquiring funds could invest in and then immediately liquidate their entire position in an ETF, exchange-traded managed fund (ETMF), listed closed-end fund, or listed BDC without having to navigate the intricacies of the redemption limit. However, if the same acquiring fund invested in an open-end mutual fund, it would be required to comply with the redemption limit. Curiously, this would appear to be the case even if the acquired ETF (no redemption limit imposed) and open-end mutual fund (redemption limit imposed) are otherwise identical securities holding the same underlying securities (i.e. different share classes of the same fund).

The likely effect of this differential treatment would be to create a regulatory advantage for exchange-listed products over non-exchange-listed products, which, in turn, would create a market preference for exchange-listed products and bias against non-exchange-listed products. To the extent this differential treatment encouraged investments in potentially more complex, less liquid, and more costly products – such as listed closed-end funds, listed BDCs and nontransparent ETFs – over plain vanilla, liquid, and low-cost open-end mutual funds, that would be a perverse and unacceptable outcome. In our view, to the extent the Commission ever provides regulatory advantages for certain investments over others, it should be based on the actual and potential risks that those investments pose to investors. This proposal could have the exact opposite effect.

---

[33] *Id*.
[34] Release at 51, footnote 128.
[35] Release at 50, footnote 124; Release at 138-139.
[36] *Id*.

In sum, we do not believe that a redemption limit in general is the best approach to safeguard against the risk that an acquiring fund may exercise undue influence over an acquired fund by threatening to engage in large-scale redemptions. And we believe that the redemption limit, as proposed, is particularly problematic for investors and fund practices. Without evidence that participation agreements aren't serving their intended purpose and aren't a viable alternative mechanism to accomplish the same goal more efficiently, we don't see why the Commission would propose an entirely new regime that has the potential to be so disruptive. However, if the Commission continues to believe that a redemption limit is the best approach, it must do more to understand the effects that it would have on fund practices and investors.

III. The requirements for an acquiring fund's adviser to make certain findings to invest in acquired funds are insufficient to protect investors from excessive fees and overly complex structures. And existing fiduciary requirements, at least as interpreted and enforced by the Commission and enforced by private investors, do not provide sufficient protections against these risks.

In order to prevent duplicative or excessive fees, existing exemptive orders require an acquiring fund's board 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. Existing exemptive orders also require an acquiring fund's adviser to waive advisory fees in certain circumstances. In addition, existing exemptive orders limit sales charges and service fees charged by an acquiring fund to those set forth in FINRA's sales charge rule.

Under the proposed rule, however, these conditions would not apply. Specifically, the acquiring fund's board would not be required to make a finding that the 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. Nor would the proposed rule require an acquiring fund's adviser to waive fees in certain circumstances. Instead, the Release states that the Commission believes these requirements are redundant in light of a fund adviser's and board's fiduciary duties and other statutory and regulatory obligations. Specifically, the Release points to the Commission's Proposed Interpretation Regarding Standard of Conduct for Investment Advisers (IA Guidance) and section 36(b) of the Investment Company Act, on the basis that these requirements ensure that the acquiring fund is not overcharged and that the acquiring fund's adviser charges a fee that bears a reasonable relationship to the services that the acquiring fund's adviser is providing.[37]

If the Commission interpreted and enforced investment advisers' fiduciary duties in a meaningful, pro-investor way, we would be more sympathetic to this argument. But the reality is that the Commission freely allows investment advisers to overcharge funds and engage in conflicts of interest, to investors' detriment. One only need look at the handful of S&P 500 funds with annual expense ratios of over 1% and the one with an annual expense ratio of 2.33%[38] for evidence that the Commission doesn't seriously enforce fiduciary duties in ways that stop advisers from overcharging in the fund context. It's frankly appalling that these products exist

[37] Release at 63-64.

[38] Rydex S&P 500 Fund Class C (RYSYX) (the expense ratio includes a 0.75% management fee, a 1% 12b-1 fee, and a 0.58% fee for "other expenses").

and that the Commission is unwilling to take a stand against them. If the Commission can't or won't act against excessive index fund fees, where there is no credible argument that investors get some advantage that justifies the added costs, it is even less likely to use its authority to rein in excessive costs in other contexts. The fact, as shown above, that BDCs routinely charge over 5% and in some cases over 10% every year is further evidence that the Commission is not seriously enforcing investment advisers' fiduciary duties.

Moreover, the Commission's reference to section 36(b) ignores the barriers that private investors face when they try to enforce the Investment Company Act fiduciary duty on their own. Section 36(b) cases are extraordinarily difficult to bring successfully, because the framework that applies to these cases is plainly tilted in favor of the fund industry. According to the U.S. Supreme Court decision, *Jones v. Harris Assoc. L.P.*, to prevail in a section 36(b) case, an investor must prove that a mutual fund adviser's fee "is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."[39] In the few cases that have been decided since *Jones* was issued, the investors unsurprisingly have not been successful, and the courts have expressed a willingness to defer to fund boards.[40] These decisions are likely to further temper any desire to bring section 36(b) cases.

The lack of Commission enforcement of investment advisers' fiduciary duties and the inability of private investors to bring section 36(b) cases on their own results in a weak deterrent mechanism, which in turn, effectively allows funds to charge duplicative or excessive fees.

The proposed rule does impose certain requirements on investment advisers, in conjunction with their fiduciary duties, including review and reporting requirements. Specifically, an acquiring fund's adviser must determine that it is in the best interest of the acquiring fund to invest in the acquired fund based on an evaluation of the complexity of the fund of funds structure and the aggregate fees associated with the investment in an acquired fund. Further, the acquiring fund's adviser must report its finding and the basis for the finding to the acquiring fund's board of directors in order to enable the board to exercise effective oversight. Additionally, the proposed rule would require the acquiring fund to maintain and preserve a written record of the adviser's finding, the basis for the finding, and the adviser's reports to the board.

These are sensible requirements as far as they go. However, it's not clear whether these requirements would result in beneficial outcomes for investors or merely introduce a process-driven approach to satisfying compliance with the rule. The main reason we are concerned that the proposed requirements may not result in beneficial outcomes for investors is that this proposal – like proposed Reg BI and the IA guidance – freely uses the phrase "best interest" but never defines it or provides any guidance on what practices would satisfy the "best interest" finding and what practices would not. On the contrary, both Reg BI and the IA Guidance make clear that conduct that is clearly not in the best interests of investors, by any objective assessment, would nonetheless satisfy its interpretation of that standard. If the Commission uses

---

[39] *Jones v. Harris Assoc. L.P.*, 559 U.S. 335, 346 (2010).

[40] *See* John W. Rotunno et al., Update on Section 36(b) Litigation, K&L Gates, 2018 Investment Management Conference Chicago, January 31, 2018, https://bit.ly/2DLwg4D.

the phrase "best interest," it must mean best of the reasonably available options, which is how any reasonable person would understand the term. However, Commission officials have consistently resisted suggestions that they should define best interest or otherwise clarify its meaning in a way that clearly requires recommending the best of the reasonably available options.

Our concern that the proposed requirements could foster a process-driven approach to satisfying compliance with the rule is reinforced by the fact that the Release offers a series of factors that an acquiring fund's adviser "should consider," with nothing more to ensure that those considerations would promote positive outcomes for investors. For example, in evaluating the complexity of a fund of funds structure, the Release states that an adviser:

- "should consider" the complexity of an acquiring fund's investment in an acquired fund versus direct investment in assets similar to the acquired fund's holdings;
- "should consider" whether the resulting structure would make it difficult for shareholders to appreciate the fund's exposures and risks;
- "should consider" whether an investment in an acquired fund would circumvent the acquiring fund's investment restrictions and limitations; and
- "should consider" whether an acquired fund invests in other funds.[41]

Moreover, in evaluating the fees associated with the fund's investment in acquired funds, the Release states that an adviser: "should consider" the fees of all tiers in the fund of funds arrangement with an eye towards duplication.[42] As part of this analysis, the Release further states that an adviser:

- "should consider" whether the acquired fund's advisory fees are for services that are in addition to, rather than duplicative of, the adviser's services to the acquiring fund;
- "should consider" sales charges and other fees, including fees for recordkeeping, sub-transfer agency services, sub-accounting services, or other administrative services. In particular, the adviser "should consider" whether these fees could be duplicative or excessive when evaluating an investment in a particular acquired fund; and
- "should consider" reviewing acquired fund share classes to ensure that the acquiring fund is not holding a more expensive share class if a less expensive one is available to the acquiring fund.[43]

After an acquiring fund's adviser "considers" all of these factors and determines that an acquired fund is in the best interest, has she complied? Under what circumstances would the Commission assert its enforcement authority and determine that the adviser's determination clearly was not in the acquiring fund's best interest? Would simply providing disclosure in the fund prospectus satisfy the adviser's obligations? Given the Commission's tepid approach to enforcement, particularly as it relates to investment advisers' fiduciary duties, we are not optimistic these requirements would serve their stated purpose.

Compounding our concern that the Commission is taking a permissive, process-oriented approach to this aspect of the rule, the proposal does not require advisers to waive fees that are

[41] Release at 61.
[42] *Id*.
[43] *Id*. at 61-62.

duplicative. Rather, the Release suggests that "fee waivers would be one way to mitigate the duplicative fee concerns."[44] It's not clear why the Commission takes such a permissive approach here, particularly when fee waivers historically have been included as a condition of exemptive relief for fund of funds arrangements. In fact, the prevalence of fund of funds arrangements that include fee waivers shows both that doing so is workable and that it directly reduces investors' expenses and improves their returns.

Without an explicit requirement to waive fees, we fear that not all fund advisers would waive fees on their own accord should they discover they are charging duplicative or excessive fees. One consequence of this could be that existing fund of funds arrangements, which include fee waivers, may eliminate or reduce those waivers, thus increasing costs for existing fund of fund investors. Given that many investors don't regularly check their funds' expense ratios and that investments (particularly target date fund investments) are often sticky, it is possible that eliminating or reducing fee waivers would go unnoticed by many investors, who would stay in funds that are then charging them more and effectively delivering less.

Further reinforcing our concerns, the proposal does not explicitly require the acquiring fund's investment adviser to invest in the lowest cost share class that's reasonably available. This is seemingly inconsistent with the Commission's proposed IA Guidance, which states that, "We believe that an adviser could not reasonably believe that a recommended security is in the best interest of a client if it is higher cost than a security that is otherwise identical…."[45] To the extent an acquiring fund's adviser decides to invest in higher cost share classes of otherwise identical securities, that should be prima facie evidence of non-compliance. The burden should then shift to the acquiring fund's adviser to justify the investment in the higher cost share class by demonstrating first, that the higher cost share class provides additional benefits that would not be available with the lower cost share class, and second, that the overall benefits to the fund and its investors outweigh the higher costs.[46]

In sum, the proposal does not go far enough to prevent funds of funds from charging duplicative or excessive fees. And evidence from the marketplace clearly shows that it is unrealistic to depend on fiduciary requirements to provide a backstop against these risks. The Commission must do more to protect against these risks. At the bare minimum, the proposal should preserve existing requirements for investment advisers to waive fees that are duplicative.

IV. The proposed restrictions on creating a multi-tiered structure are warranted.

As discussed above, one Congressional concern underlying section 12(d)(1) was that complex, multi-tier fund structures may lead to excessive fees and investor confusion. Under existing fund of funds exemptive orders, acquired funds are generally prohibited from investing in other funds beyond the limits in section 12(d)(1). However, because existing orders do not

[44] Release at 61.

[45] Proposed IA Guidance at 12. However, the IA Guidance raises questions about whether disclosure alone that the adviser has recommended an otherwise identical security with a higher cost would satisfy that standard.

[46] One example might be the ability for the fund of funds to have a significantly lower minimum than would be available if the fund of funds purchased lower cost share classes. However, in such a situation, we would expect the fund of funds to also offer a lower cost share class for investors who attain enough assets to qualify to purchase the underlying funds with lower share classes.

expressly prohibit a fund from investing in an acquiring fund beyond the limits in section 12(d)(1), fund of funds can currently create more than two tiers of funds, which allows acquiring funds to acquire other acquiring funds.

Notably, the proposed rule would broaden and strengthen the conditions that apply to the creation of multi-tiered structures. Specifically, a fund would not be permitted to acquire the outstanding voting securities of a fund that discloses in its registration statement that it may be an acquiring fund under the proposed rule. Thus, an acquiring fund would not be allowed to invest in another acquiring fund, which would effectively limit fund of funds arrangements to two levels.

We strongly support this requirement and believe it would enhance investor protections. As the Commission rightly points out, multi-tier structures historically have been associated with duplicative and excessive fees and investor confusion.[47] Further, we agree that, although multi-tier structures may, in certain circumstances, provide efficient and cost-effective exposure to certain markets, multi-tier structures can obfuscate the fund's investments, fees, and related risks.[48]

Based on our review of several multi-tier funds of funds, for example, peeling back the different layers of investments and understanding them can be quite challenging. For example, one fund that we reviewed holds approximately 25 other funds, including some that are part of the same fund family and some that aren't. Of those funds that the fund holds, one is itself a fund of funds, with a relatively complex investment and trading strategy. The result is a very complex and relatively opaque fund of funds (of funds) arrangement that required us to use multiple spreadsheets to determine what underlying investments are being held at the various levels. We doubt your average unsophisticated retail investor, who this fund appears to be marketed to, would be willing or able to do this type of analysis. For these reasons, we believe that, on balance, the benefits of restricting multi-tier structures outweigh the costs.

We understand others may argue that concerns about complex structures are mitigated by funds' disclosures. While disclosures certainly help some investors make informed fund of funds investment decisions, the reality is many if not most retail investors don't read the disclosures they receive, and if they do read them, they are unlikely to fully understand them.[49] Adding multiple layers of funds would only increase the likelihood that retail investors, most of whom are unsophisticated, wouldn't understand them in any meaningful way. This could result in fund of funds investors' buying and holding funds that don't match their needs and expose them to excessive fees or risks.

---

[47] Release at 149-150.

[48] Release at 83.

[49] *See* Study Regarding Financial Literacy Among Investors As Required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Staff of the U.S. Securities and Exchange Commission, August 2012, https://bit.ly/1RXrU76; Nathan Mauck and Leigh Salzsieder, Diversification Bias and the Law of One Price: An Experiment on Index Mutual Funds (finding that individual investors selected high-fee index mutual funds despite the fact that the future payouts were nearly identical and that disclosure did not mitigate the problem); Jason Zweig, No One Needs Paper Piles; SEC Should Get Smart About Broker Disclosure, Wall Street Journal, July 27, 2018, https://on.wsj.com/2AUFjRK (quoting Nobel Prize winning economist, Richard Thaler, saying, "no one reads them [investor disclosures]."

V. The economic analysis is weak and incomplete, and it's clear the Commission does not adequately understand what impacts the proposed rule would likely have.

This proposed rule is exceedingly complex and it could have a range of impacts on the market and investors. Unfortunately, the Release provides unsettling evidence that the Commission does not have an adequate understanding of the likely effects that the rule would have. The Release's economic analysis is littered with statements that underscore this point, including:

- "**[W]e are unable to reliably quantify** many of the economic effects in light of the uncertainty about how market participants would react to the changes in regulatory structure under the rule proposal. For example, **we are unable to estimate** the number of new funds of funds that potentially would be created as a result of the adoption of the rule proposal, because **we do not have information** about the extent to which the exemptive order application process and the conditions associated with exemptive relief limit the creation of funds of funds. Further, **we do not have information** needed to estimate likely changes in investor demand for funds of funds following the potential adoption of the rule proposal. Therefore, much of the discussion below is qualitative in nature, although we try to describe, where possible, the direction of the economic effects."[50]

After acknowledging that the Commission does not have a clear understanding of the impacts that the rule proposal would have, the Release's economic analysis offers a series of potential impacts that it could have. These run the gamut. The Release states, for example:

- "The impact of the rule proposal on the efficiency of current and prospective acquiring funds' asset allocation is unclear ex-ante. On one hand, the rule proposal could promote the efficiency of funds' asset allocation….On the other hand, the rule proposal could reduce the efficiency of funds' asset allocation…"[51]
- "The impact of the rule proposal on the efficiency of the asset allocation of current and prospective acquiring fund investors is unclear ex-ante. On one hand, the rule proposal could promote the efficiency of investors' asset allocation….On the other hand, the rule proposal could reduce the efficiency of investors' asset allocation."[52]
- "The impact of the rule proposal on the efficiency of prices is unclear ex-ante. On one hand, the rule proposal could harm the efficiency of prices of the underlying assets of acquired funds….On the other hand, the rule proposal could have a positive impact on the efficiency of the prices of acquired funds and their underlying assets."[53]
- "The impact of the rule proposal on fund competition is unclear ex-ante…On one hand, the rule proposal could promote competition in the fund industry for the following reasons. First, to the extent that proposed rule 12d1-4 would increase acquiring funds' investment flexibility, the proposed rule could promote competition in the fund industry…On the other hand, to the extent that the rule proposal would decrease funds' investment flexibility, it could harm competition among funds of funds."[54]
- "The impact of the rule proposal on capital formation is unclear ex-ante. On one hand, the rule proposal could have a positive effect on capital formation…. On the other hand,

[50] Release at 117 (bolded for emphasis).
[51] Release at 153-154.
[52] Release at 155-156.
[53] Release at 156-157.
[54] Release at 158-159.

> assuming that single-tier funds and funds of funds are purely substitute investments…there would be no change in the amount of money that flows to corporations and there would be no impact on capital formation as a result of the rule proposal."[55]

This approach to economic analysis, first stating that the impact of a proposed rule is unclear ex ante, then stating that "on the one hand" the proposal could have one set of impacts, but "on the other hand" it could have the exact opposite set of impacts, is unacceptable. If the Commission is going to engage in rulemaking, particularly in an area that has the potential to affect retail investors in significant ways, the Commission should have a solid understanding of the likely impacts a rule proposal would have, even if it can't quantify them with precision. At the very least, it should be able to describe which outcome it believes is more likely and why. This is particularly the case where, as here, nothing is fundamentally broken with the existing regulatory framework that demands a regulatory response. As the Commission's economic analysis shows, there are over 4,300 fund of funds arrangements, which demonstrates that fund providers are able to create, and investors are able to access, a variety of fund of funds arrangements.[56] Overhauling the regulatory regime based on an inadequate understanding of the effects that such an overhaul would have, as the Commission proposes to do here, is a risk the Commission should not be so willing to undertake.

Conclusion

While formalizing a more consistent and streamlined approval process for fund of funds arrangements is a reasonable goal, and one that we would support, this proposal goes well beyond that objective. Under the existing exemptive order process, the Commission is able to stop potentially harmful products that raise the same concerns Congress intended to address through section 12(d)(1) of the Investment Company Act from coming to market. However, under the proposed rule, it is inevitable that new fund of funds arrangements that are detrimental to investors and that would not pass muster under the individual exemptive process would come to market, because the Commission wouldn't be scrutinizing each arrangement as closely as it does currently. The likely result is that retail investors would risk being harmed in ways that they aren't currently. That would be a terrible outcome. It's far better to protect investors on the front end than try to repair damage after the fact, particularly because the avenues for recourse for harmed investors are so limited.

If the Commission does move forward with this proposal, it must do a better job to ensure that this rulemaking would result in better outcomes for everyone, particularly unsophisticated retail investors, who are the primary beneficiaries of – and who have the most to lose from harmful – fund of funds arrangements.

Respectfully submitted,

Micah Hauptman
Financial Services Counsel

---

[55] Release at 159-160.
[56] Release at 102.