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May 2, 2019

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

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

Dear Ms. Countryman:

The Asset Management Group (the "**AMG**") of the Securities Industry and Financial Markets Association ("**SIFMA**")[1] appreciates the opportunity to provide comments to the United States Securities and Exchange Commission (the "**Commission**") on the Commission's proposed new Rule 12d1-4 under the Investment Company Act of 1940, as amended (the "**Investment Company Act**" or the "**1940 Act**"), that would streamline and enhance the regulatory framework applicable to funds that invest in other funds ("fund of funds" arrangements) (the "**Proposed Rule**"). In addition, AMG is also providing comments on the Commission's proposal to rescind Rule 12d1-2 and certain exemptive orders that have been granted to funds of funds and their sponsors, as well as the proposed amendments to Rule 12d1-1 (together with the Proposed Rule, the "**Proposal**").[2]

While AMG supports the object of the Proposal – to streamline and enhance the regulatory framework applicable to funds of funds and to create a consistent and efficient rules-based regime for the formation and oversight of funds of funds – we believe that the Proposal will unnecessarily disrupt many existing fund of funds arrangements. To assist the Commission in improving the Proposed Rule, AMG sets forth below a number of specific comments and suggestions regarding the Proposal.

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[1] SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's member firms represent U.S. and global asset management firms whose combined assets under management exceed $45 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds. For more information, visit http://www.sifma.org/amg.

[2] Fund of Funds Arrangements, Release No. IC-33329 (Dec. 19, 2018), 84 Fed. Reg. 1286 (Feb. 1, 2019), *available at* https://www.sec.gov/rules/proposed/2018/33-10590.pdf (the "**Proposing Release**").

A. Executive Summary

AMG believes that most existing fund of funds arrangements will be needlessly disrupted if the Proposal is adopted without changes. The Proposed Rule's 3% Redemption Limit (as defined below) will force many funds to either change their operations to comply with this entirely new requirement under the Proposed Rule, or to change their operations to avoid having to comply with the Proposed Rule. Similarly, the proposal to rescind Rule 12d1-2 and most exemptive orders providing relief from Section 12(d)(1) will likewise cause many advisers to restructure fund of funds arrangements that have been specifically tailored to operate pursuant to Rule 12d1-2 or an individual Section 12(d)(1) exemption. In our view, there is no clear rationale given in the Proposing Release for imposing the 3% Redemption Limit, especially in the case of affiliated funds of funds that currently operate under Section 12(d)(1)(G) and Rule 12d1-2, or for rescinding Rule 12d1-2 and various Section 12(d)(1) exemptions without proposing a non-disruptive alternative. Therefore, we set forth below our suggestions regarding how the Commission can modify the Proposal to avoid some of the disruption it will cause.

The decision to invest in another fund, just like the decision to invest in a particular stock, bond or other asset, is an investment decision that properly falls within the discretion of the investing fund's portfolio manager. With this in mind, we propose an alternative framework that clarifies that advisers to funds of funds are free to determine when and to what extent to invest in other funds as long as the determination to invest in another fund is in the best interest of the investing fund. This framework includes "guardrails" that are designed to address the concerns that Congress and the Commission have articulated over the years in adopting and amending Section 12(d)(1) and related rules, but, at the same time, it acknowledges that, as a fiduciary to the investing fund, the adviser has a duty to act in a manner that it perceives to be in that fund's best interest. In this vein, we believe the 3% Redemption Limit is unnecessary, especially for affiliated funds of funds, and should be eliminated. In its place, we recommend that the Commission adopt a rules-based approach that requires advisers to acquiring funds in unaffiliated funds of funds to operate in the best interest of the acquiring funds, to make a representation with respect to each acquired fund that it invests in that the acquiring fund will not exercise undue influence, overreach, take into account the compensation received by the acquiring fund or its affiliates, or seek to exercise control over the acquired fund, and to establish appropriate policies and procedures to ensure compliance with these provisions.

In addition, unless the Proposed Rule is amended to permit Section 12(d)(1)(G) funds of funds to operate as they currently do under the 1940 Act, Rule 12d1-2 and other existing relief, the Commission should not rescind Rule 12d1-2 and various Section 12(d)(1) exemptions. In fact, AMG recommends that the Commission incorporate into the Proposed Rule (or otherwise confirm the continuing availability of) the flexibility afforded to funds today under various no-action letters and exemptions, as this would be consistent with Congress's most recent direction to the Commission that the Commission should use its authority to grant exemptions from Section 12(d)(1) "in a progressive way."

Finally, we provide a number of specific comments and suggestions on a variety of topics that are of concern to our members.

B. Background

Current Regulation of Fund of Funds Arrangements.

Section 12(d)(1) of the 1940 Act provides the regulatory framework that governs fund of funds arrangements. The limitations in Sections 12(d)(1)(A), (B), and (C) reflect Congress's efforts to address "pyramiding," which was a practice under which investors could use a limited investment in an acquiring fund to control an acquired fund in order to enrich themselves at the expense of the acquired fund's shareholders.[3] In Congress's view, control could be exercised either directly (by exercise of the voting power associated with holding a controlling interest) or indirectly (by coercion through the threat of large-scale redemptions). Congress also was concerned about the potential for excessive fees when one fund invested in another,[4] and the formation of overly complex structures that could confuse investors.[5]

Section 12(d)(1)(A) prohibits a registered fund (and companies, including funds, it controls)[6] from (1) acquiring more than 3% of another fund's outstanding voting securities; (2) investing more than 5% of its total assets in any one fund; and (3) investing more than 10% of its total assets in funds generally. Section 12(d)(1)(B) prohibits an acquired fund that is a registered open-end investment company (as well as the fund's principal underwriter and any broker-dealer) from knowingly selling securities to an acquiring fund if the acquiring fund would (1) together with companies it controls, own more than 3% of the acquired fund's outstanding voting securities; or (2) together with other funds (and companies they control), own more than 10% of the acquired fund's outstanding voting securities. Section 12(d)(1)(C) prohibits investment companies from investing in a registered closed-end fund if the investment company (together with companies it controls) would own more than 10% of the closed-end fund's outstanding voting securities.

Sections 12(d)(1)(E), (F), and (G) permit different types of fund of funds arrangements by providing statutory exemptions from the prohibitions of Section 12(d)(1), subject to certain conditions. Section 12(d)(1)(E) allows a registered or unregistered fund to invest all of its assets in the securities of a single other fund so that the fund is, in effect, a conduit through which investors may access the other fund (*i.e.*, a master-feeder structure).[7] Section 12(d)(1)(F) permits a registered fund to take small positions (collectively with its affiliates, up to 3% of another fund's outstanding securities) in an

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[3] *See* Hearings on H.R. 10065 before the Subcomm. of the House Comm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess., 112-14 (1940) (statement of David Schenker); Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, pt. 3, ch. 4, H.R. Doc. No. 136, 77th Cong., 1st Sess., 1031-1041, notes 58-59 (1941) ("**Investment Trust Study**"); *id.* at ch. 7, 2742-50. *See also* Exchange-Traded Funds, Investment Company Act Release No. 28193 (Mar. 11, 2008) ("**2008 Proposing Release**"), at note 195 (discussing the legislative history of "pyramiding schemes").

[4] *See* Investment Trust Study, *supra* note 3, at ch. 7, 2725-39, 2760-75, 2778-93.

[5] *See id*. at 2778-93.

[6] "Control" is defined in Section 2(a)(9) of the 1940 Act as the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company. The 1940 Act also creates a rebuttable presumption that any person who directly or indirectly beneficially owns more than 25% of the voting securities of a company controls the company and that one who does not own that amount does not control it. A determination of control depends on the facts and circumstances of the particular situation.

[7] Section 12(d)(1)(E) requires, among other conditions, that the shares of the acquired fund are the only investment securities held by the acquiring fund and that the acquiring fund is obligated to either (i) seek voting instructions from its shareholders and vote such proxies in accordance with their instructions ("pass through voting") or (ii) vote the shares held by it in the same proportion as the vote of all other holders of the acquired fund ("mirror voting").

unlimited number of other funds.[8] Section 12(d)(1)(G) permits a registered open-end fund or a registered unit investment trust ("**UIT**") to invest in other registered open-end funds and registered UITs that are in the same "group of investment companies"[9] in excess of the limitations in Section 12(d)(1)(A) and (B), so long as other investments held by the fund or UIT are limited to government securities and short-term paper.[10]

At the same time Section 12(d)(1(G) was added to the 1940 Act in 1996, Congress authorized the Commission to exempt any person, security or transaction, or any class or classes of transactions, from Section 12(d)(1) of the 1940 Act if the exemption is consistent with the public interest and the protection of investors, and directed that the Commission use this authority "in a progressive way."[11]

The Commission has from time to time granted individualized relief from Sections 12(d)(1)(A), (B), (C), and (G) pursuant to this authority by issuing exemptive orders (the "**12(d)(1) exemptive orders**"). The 12(d)(1) exemptive orders permit fund investments in other funds subject to specified conditions, and have been relied upon, among other purposes, to engage in interfund borrowing and lending transactions,[12] to invest for short-term cash management purposes,[13] and, in combination with reliance on Section 12(d)(1)(G), to employ "central" funds and various multi-tier fund structures.[14] Relief from Sections 12(d)(1)(A) and (B) also is included in the exemptive orders issued by the Commission that allow exchange-traded funds ("**ETFs**")[15] and exchange-traded managed funds ("**ETMFs**") to operate.[16]

In 2006, the Commission adopted Rules 12d1-1, 12d1-2 and 12d1-3 to broaden the ability of funds to invest in other funds.[17] Rule 12d1-1 allows a fund to invest in shares of a money market fund in

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[8] An acquiring fund relying on Section 12(d)(1)(F) may be restricted, at the acquired fund's election, from redeeming more than 1% of the acquired fund's total outstanding securities during any period of less than thirty days, and must mirror vote or pass through the vote on acquired fund shares.

[9] Section 12(d)(1)(G)(ii) defines "group of investment companies" to mean any two or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services. The Commission staff has interpreted this term to include funds with the same adviser or whose advisers are under common control. *See MassMutual Institutional Funds*, Staff No-Action Letter (pub. avail Oct. 19, 1998), *available at* https://www.sec.gov/divisions/investment/noaction/1998/massmutual101998.pdf.

[10] In addition to the limitations on investments by acquiring funds noted above, Section 12(d)(1)(G) also places limits on the fees paid by the acquiring fund for distribution-related activities and on the sales load or other fees or charges for distribution-related activities by the acquiring fund. The acquired fund also must have a policy that prohibits it from acquiring securities of registered open-end investment companies or registered UITs in reliance on Sections 12(d)(1)(F) or (G).

[11] Comm. On Commerce, Securities Amendments of 1996, H.R. Rep. No. 104-622 (1996), 104th Cong., 2nd Sess. ("**H.R. Rep. No. 104-622**"), at 44-45.

[12] *See, e.g.*, Franklin Alternative Strategies Funds, et al., Investment Company Act Release Nos. 33095 (May 10, 2018) (notice) and 22117 (June 5, 2018) (order).

[13] *See, e.g.*, Putnam American Government Income Fund, Investment Company Act Release Nos. 26200 (Oct. 1, 2003) (notice) and 26414 (April 9, 2004) (order).

[14] *See, e.g.*, PIMCO Funds, et al., Investment Company Act Release Nos. 25220 (Oct. 22, 2001) (notice) and 25272 (Nov. 19, 2001) (order).

[15] *See, e.g.*, iShares Trust, et al., Investment Company Act Release Nos. 29129 (Feb. 16, 2010) (notice) and 29172 (Mar. 10, 2010) (order).

[16] *See, e.g.*, Eaton Vance Management, et al., Investment Company Act Release Nos. 31333 (Nov. 6, 2014) (notice) and 31361 (Dec. 2, 2014) (order).

[17] Notably, the Commission did not rescind the exemptive orders that funds had relied upon in connection with these types of arrangements when adopting these rules.

excess of the limits of Sections 12(d)(1)(A) and (B). Rule 12d1-2 permits a fund relying on Section 12(d)(1)(G) to invest in other securities (including stocks and bonds), money market funds (in reliance on Rule 12d1-1), and securities of funds that are not part of the same group of investment companies (in reliance on Sections 12(d)(1)(A) or (F)).[18]

In addition, the Commission staff has provided advisers with additional flexibility to create and operate certain types of fund of funds arrangements pursuant to "no-action" letters that are based on specific facts and circumstances and subject to specified conditions. These no-action letters have permitted, among other arrangements, (1) a fund relying on Section 12(d)(1)(G) to also invest a portion of its assets in investments that may not be securities;[19] (2) a fund relying on Section 12(d)(1)(G) to invest in an underlying fund that in turn relies on Section 12(d)(1)(G) to invest in a third-tier "central fund" for purposes of centralizing the portfolio management of floating rate or other instruments;[20] and (3) affiliated foreign funds to invest in U.S.-registered investment companies beyond the limits of 12(d)(1)(A)(B) and (C).[21]

It is against this complex regulatory backdrop that the Commission advanced the Proposal.

2018 Fund of Funds Rule Proposal.

The Proposed Rule was designed to streamline and enhance the regulation of fund of funds arrangements. The Proposing Release noted that the current combination of statutory exemptions, Commission rules and exemptive orders has created a regime in which substantially similar fund of funds arrangements are subject to different conditions. The Proposal is intended to replace the existing regime in order "to create a more consistent and efficient regulatory framework for fund of funds arrangements."[22]

Proposed Rule 12d1-4

The Proposed Rule is designed to replace the existing regime with a new comprehensive fund of funds framework. Subject to specific conditions described below, and notwithstanding the limits in Sections 12(d)(1)(A), (B) and (C), the Proposed Rule would allow:

[18] Rule 12d1-3 permits certain Section 12(d)(1)(F) funds to acquire securities issued by an acquired fund to offer or sell its securities at a public offering price that includes a sales charge of more than 1½% as long as any sales charges and service fees charged do not exceed applicable limits in FINRA Rule 2341.

[19] *See Northern Lights Fund Trust*, Staff No-Action Letter (pub. avail. Jun. 29, 2015) ("***Northern Lights*** **no-action letter"**).

[20] *See, e.g., Franklin Templeton Investments,* Staff No-Action Letter (pub. avail. Apr. 3, 2015) ("***Franklin Templeton*** **no-action letter**"); *Thrivent Financial for Lutherans and Thrivent Asset Management LLC*, Staff No-Action Letter (pub. avail. Sep. 27, 2016) ("***Thrivent*** **no-action letter**").

[21] See *Dechert LLP*, Staff No-Action Letter (pub. avail. Aug. 24, 2009) ("***Dechert*** **no-action letter**").

[22] Proposing Release, *supra* note 2, at 13. Although this goal is conceptually similar to the Commission's rationale for proposing a new rule governing ETFs (*see* Exchange-Traded Funds, Investment Company Act Release No. 33140 (Jun. 28, 2018)), there is a key difference. In the ETF space, the exemptive orders have created and reinforced an uneven playing field that provides significant competitive advantages to certain ETF sponsors. In contrast, in the fund of funds space, despite programs being structured differently in reliance on a variety of regulatory authorities, most funds of funds operate in roughly the same manner and there is no privileged class of fund of funds sponsors.

i. A registered investment company or business development company ("**BDC**") (collectively, "**acquiring funds**")[23] to acquire the securities of any other registered investment company or BDC (collectively, "**acquired funds**");

ii. An acquired fund, its principal underwriter and any broker-dealer to sell the acquired fund's securities to any acquiring fund; and

iii. An acquired fund to redeem or repurchase its securities issued to an acquiring fund.

Currently, permitted fund of funds arrangements vary based on the type of acquiring fund and the type of acquired fund. The Proposed Rule would generally expand the types of fund of funds arrangements, permitting investment companies and BDCs to invest in other types of investment companies and BDCs (including unlisted closed-end funds and unlisted BDCs) in amounts that exceed the limits specified in Section 12(d)(1). The Proposed Rule would also allow funds of funds to invest in individual securities and derivatives.

To rely on the Proposed Rule, a fund of funds arrangement would be required to satisfy various conditions intended to protect investors from the same harms that Congress sought to prevent by enacting Section 12(d)(1): (i) an acquiring fund exercising undue influence (for example, through the voting power of a controlling interest or the threat of large-scale redemptions) to benefit its shareholders at the expense of the acquired fund's other shareholders, (ii) duplicative and excessive fees that may result when one fund invests in another and (iii) overly complex structures that historically have been associated with excessive fees and confusion among investors about who controls their fund and the value of their investments. The Proposed Rule's conditions fall into four categories:

1. Control

Under the Proposed Rule, an acquiring fund and its "advisory group"[24] would not be permitted to "control" an acquired fund. Control would be determined pursuant to Section 2(a)(9) of the 1940 Act. Thus, up to 25% of an acquired fund's shares normally could be acquired by an acquiring fund and its "advisory group." If an acquiring fund and its advisory group became a holder of more than 25% of an acquired fund's shares "passively" (*e.g.*, as a result of redemptions by other shareholders of the acquired fund), the Proposed Rule would not require an acquiring fund to divest itself of the acquired fund's shares.

Also under the Proposed Rule, if an acquiring fund and its advisory group, in the aggregate, held more than 3% of the outstanding voting securities of an acquired fund, each of the holders must vote the securities in the manner prescribed by Section 12(d)(1)(E)(iii)(aa) (*i.e.*, using either pass-through voting or mirror voting the shares). These conditions would not apply if (i) the acquiring fund is in

[23] Private funds and unregistered investment companies (including investment companies organized outside of the United States that do not offer or sell their securities in the United States in connection with a public offering) are outside the Proposed Rule's scope of acquiring funds. As a result, the Proposed Rule would have no effect on the ability of these funds to invest in registered investment companies, including BDCs.

[24] As defined in the Proposed Rule, "advisory group" means "either (1) an acquiring fund's investment adviser or depositor, and any person controlling, controlled by, or under common control with such investment adviser or depositor; or (2) an acquiring fund's investment sub-adviser and any person controlling, controlled by, or under common control with such investment sub-adviser." *See* Proposed Rule 12d1-4(d). Under the Proposed Rule, an acquiring fund would not combine the entities listed in clause (1) with those listed in clause (2).

the same "group of investment companies"[25] as an acquired fund or (ii) the acquiring fund's investment sub-adviser or any control affiliate of the sub-adviser is the adviser or depositor of the acquired fund.

2. <u>3% Redemption Limit</u>

Under the Proposed Rule, an acquiring fund that holds more than 3% of an acquired fund's outstanding voting shares would not be permitted to redeem or tender for repurchase more than 3% of the acquired fund's outstanding shares during any thirty-day period in which the acquiring fund holds the acquired fund's shares in excess of the 3% limit (the "**3% Redemption Limit**").[26] Sales of shares of an acquired fund on the secondary market (*e.g.*, listed closed-end fund shares or ETF shares) would not be subject to the 3% Redemption Limit.

3. <u>Fees and Other Considerations</u>

Under the Proposed Rule, *if an acquiring fund is an open-end fund or closed-end fund (including a BDC)*, the acquiring fund's investment adviser must evaluate the complexity of the structure and aggregate fees associated with the acquiring fund's investment in the acquired fund, and find that it is in the best interest of the acquiring fund to invest in the acquired fund. The acquiring fund's investment adviser must report its finding and the basis for the finding to the acquiring fund's board of directors/trustees before investing in an acquired fund for the first time and at least annually thereafter.

If an acquiring fund is a UIT, the UIT's principal underwriter or depositor must evaluate the complexity of the structure and the aggregate fees associated with the UIT's investment in acquired funds and, on or before the date of initial deposit of portfolio securities into the UIT, find that the UIT's fees do not duplicate the fees of the acquired funds that the UIT holds or will hold at the date of deposit.

4. <u>Avoiding Complex Fund Structures</u>

An investment company intending to rely on the Proposed Rule must disclose in its registration statement if it is, or at times may be, an acquiring fund relying on the Proposed Rule. In order to limit the creation of multi-tier arrangements, the Proposed Rule prohibits an investment company that relies on Section 12(d)(1)(G) or the Proposed Rule from acquiring, in excess of the limits in Section 12(d)(1)(A), the outstanding voting securities of another investment company that disclosed in its most recent registration statement that it may be an acquiring fund under the Proposed Rule. In addition, the Proposed Rule prohibits an acquired fund from acquiring the securities of another investment company, or companies that would be investment companies but for the exclusions in

[25] As defined in the Proposed Rule, "group of investment companies" means "any two or more registered investment companies or business development companies that hold themselves out to investors as related companies for investment and investor services." *See* Proposed Rule 12d1-4(d). This definition adds BDCs to the definition of "group of investment companies" in Section 12(d)(1)(G).

[26] The Proposing Release notes that an acquiring fund relying on Section 12(d)(1)(G)'s statutory exemption from Section 12(d)(1)(A) (as opposed to the Proposed Rule) may acquire more than 3% of an acquired fund's shares without being subject to any redemption limits, provided the acquired fund is in the same group of investment companies and is structured as an open-end fund or UIT. *See* Proposing Release, *supra* note 2, at 51, note 129. However, with the proposed rescission of Rule 12d1-2, such funds would have to strictly adhere to the conditions of Section 12(d)(1)(G).

Sections 3(c)(1) or 3(c)(7) under the 1940 Act ("**3(c)(1)/3(c)(7) Funds**"), in excess of the limits in Section 12(d)(1)(A), unless the acquired fund's investment is:

i. Made in reliance on Section 12(d)(1)(E) (*i.e.*, a master-feeder relationship);

ii. For short-term cash management purposes under Rule 12d1-1 or exemptive relief from the Commission;

iii. In a subsidiary that is wholly owned and controlled by the acquired fund;

iv. The receipt of securities as a dividend or as a result of a plan of reorganization of a company; or

v. Made in reliance on exemptive relief from the Commission to engage in interfund borrowing and lending transactions.

Rescission of Rule 12d1-2 and Most Section 12(d) Exemptive Orders; Amended Rule 12d1-1

Because the Proposed Rule is intended to be a comprehensive exemptive rule, the Commission has proposed to rescind Rule 12d1-2, as well as most Section 12(d)(1)(A), (B), (C) and (G) exemptive orders. With the rescission of Rule 12d1-2, fund of funds arrangements that rely on Section 12(d)(1)(G) would lose the flexibility to invest in unaffiliated money market fund securities in reliance on Rule 12d1-1.[27] To provide funds relying on Section 12(d)(1)(G) with continuing flexibility to invest in money market funds outside of their "group of investment companies," the Proposal would amend Rule 12d1-1 to permit such investments.

Overview of the U.S. Fund of Funds Industry.

In the Proposing Release, the Commission observed that "funds increasingly invest in other funds," with the Commission staff estimating that, as of August 2018, nearly one half of all registered funds held investments in other funds.[28] The Proposing Release highlighted the substantial increase in fund of funds arrangements and assets in recent years, noting that the number of mutual funds that invest primarily in other mutual funds had grown from 839 in 2008 to 1,400 in 2017, and that total net assets in such funds had grown from $469 billion to $2.22 trillion over the same period.[29]

AMG believes that the significant growth over time in both the total number of fund of funds arrangements and the total net assets invested in those arrangements is a function of the important benefits funds of funds offer their shareholders. By investing in another fund, a fund of funds may gain exposure to a particular investment strategy, market, or asset class in an efficient and cost-effective manner. Funds also may invest in other funds to equitize portfolio cash, engage in hedging transactions, or manage risk in an effort to enhance risk-adjusted returns. Fund of funds arrangements

[27] Funds relying on Section 12(d)(1)(G) would also lose the ability to acquire shares of unaffiliated investment companies and securities such as stocks and bonds if Rule 12d1-2 is rescinded. If such a fund wishes to continue to invest in those instruments or to invest in non-securities such as derivatives, it would have to operate under the Proposed Rule and subject itself to the 3% Redemption Limit.

[28] Proposing Release, *supra* note 2, at 7.

[29] *Id.* at note 5, *citing to* Investment Company Institute, 2018 Investment Company Fact Book (2018), at 256, *available at* https://www.ici.org/pdf/2018_factbook.pdf. According to the Proposing Release, between January 2017 and June 2018, 0.76% (0.16%) of the redemptions of listed (unlisted) acquired fund shares exceeded the 3% redemption limit. *Id.* at note 125.

offer a convenient way for investors to allocate and diversify their investments through a single, professionally managed portfolio. In many target date funds, for instance, allocations among underlying funds are adjusted over time to provide an appropriate risk/return profile for investors as the fund approaches a particular target date, without the need for investors to rebalance their own portfolios. In some circumstances, a fund of funds may also provide an investor with exposure to a particular investment strategy or asset class that may not otherwise be available to that investor. In this way, funds of funds contribute to the Commission's goal of supporting "Main Street" investors.

SIFMA AMG Fund of Funds Survey

To provide additional context regarding the fund of funds industry, AMG recently conducted a survey of its members in connection with the Proposal (the "**Survey**"). As the Survey results show, the adoption of the Proposal will have a significant impact on the fund of funds business, affecting millions of investors and trillions of client assets. Fifteen firms responded to the Survey, representing 655 funds of funds[30] with assets of nearly $1.8 trillion.[31] The 655 funds of funds are broken down as follows:

- 532 mutual funds with assets of $1.76 trillion,
- 105 UITs with assets of $751.6 million, and
- 38 ETFs with assets of $10.5 billion.

Of the 655 funds of funds sponsored by Survey respondents, 223 of them hold more than 3% of an acquired fund's shares. For the period from January 1, 2018 through March 1, 2019, over 500 funds sponsored by Survey respondents redeemed more than 3% of a single acquired fund's assets in a single redemption.[32]

In establishing and operating these fund of funds arrangements, Survey respondents rely on a variety of authorities (often in combination), including Sections 12(d)(1)(F)[33] and 12(d)(1)(G),[34] Rule 12d1-2,[35] individual Commission exemptive orders[36] and no-action letters.[37] With respect to what these funds of funds invest in, all fifteen Survey respondents indicated that they sponsor funds that invest in affiliated open-end funds and UITs, while thirteen sponsor funds that invest in unaffiliated open-end funds and UITs, four sponsor funds that invest in affiliated "central" funds,[38] two sponsor funds that invest in affiliated unregistered funds, two sponsor funds that invest in unaffiliated closed-

[30] For purposes of the Survey, we defined "fund of funds" as funds that seek to achieve their investment objective by investing substantially all of their assets (>85% of fund assets) in shares of other investment companies.

[31] These fifteen firms include many of the world's largest asset managers. Collectively, they have assets under management in excess of $21 trillion, and fund of funds represent approximately 8.6% of those assets.

[32] This includes both affiliated and unaffiliated fund of funds arrangements, although about 90% of such redemptions occurred in affiliated funds of funds. If the Survey were to include redemptions made over a 30-day period, there would be an even greater number of >3% redemptions.

[33] Five firms.

[34] Fourteen firms.

[35] Fourteen firms.

[36] Fourteen firms.

[37] Three firms.

[38] "Central" funds are typically registered or unregistered funds that charge no management fee and are available only to funds within the same complex. They often seek to offer efficient, low cost access to certain core asset classes that form part of a larger portfolio.

end funds, one sponsors funds that invest in unaffiliated BDCs and one sponsors funds that invest in unaffiliated unregistered funds. The funds of funds sponsored by Survey respondents that invest in affiliated open-end funds in reliance on Section 12(d)(1)(G) also invest in unaffiliated money market funds,[39] unaffiliated registered investment companies,[40] individual securities such as stocks and bonds,[41] and non-securities such as certain derivatives or real estate.[42]

The Survey also requested information regarding funds that make investments in other investment companies beyond the limits of Section 12(d)(1)(A) but where those investments, in the aggregate, represent less than 85% of fund assets. Eight Survey respondents sponsor such funds, with all eight sponsoring funds that invest in open-end funds, one sponsoring funds that invest in closed-end funds, and three sponsoring funds that invest in ETFs. In sponsoring funds of funds that make these investments, these firms rely upon Section 12(d)(1)(F),[43] Section 12(d)(1)(G),[44] exemptive orders,[45] Rule 12d1-1[46] and Rule 12d1-2.[47] With respect to what these fund of funds invest in, eight Survey respondents indicated that they sponsor funds that invest in affiliated open-end funds and UITs, while seven sponsor funds that invest in unaffiliated open-end funds and UITs, three sponsor funds that invest in affiliated "central" funds, two sponsor funds that invest in unaffiliated closed-end funds, two sponsor funds that invest in unaffiliated BDCs, one sponsors funds that invest in affiliated unregistered funds, and one sponsors funds that invest in unaffiliated unregistered funds. Fifty-nine of these funds hold more than 3% of an acquired fund's shares, and there have been dozens of redemptions of more than 3% of an acquired fund's shares during the period from January 1, 2018 through March 1, 2019.[48]

Finally, the Survey included questions regarding multi-tier fund of funds structures. Eight Survey respondents indicated that they employ multi-tier structures, with seven respondents using three-tiered structures and one respondent using a four-tiered structure. Four of these respondents use one or more "central" funds and one uses an affiliated private fund in connection with a multi-tier structure, while two respondents use these structures to enable a fund of funds to invest in affiliated unregistered funds. While the respondents rely on various authorities to operate multi-tier structures, the Survey indicates that seven respondents operate these structures pursuant to exemptive orders, while three other respondents operate in reliance on Section 12(d)(1)(G), three respondents in reliance on Rule 12d1-2, two respondents in reliance on Section 12(d)(1)(A), two respondents in reliance on

[39] Four firms sponsor funds that invest in money market funds in reliance on Rule 12d1-1, one sponsors funds that invest in reliance on Rule 12d1-2 and one sponsors funds that invest in reliance on an exemptive order.
[40] Seven firms sponsor funds that invest in unaffiliated registered investment companies in reliance on Rule 12d1-2, and seven sponsor funds that invest in reliance on an exemptive order.
[41] Eleven firms sponsor funds that invest in securities in reliance on Rule 12d1-2, while two sponsor funds that invest in reliance on exemptive orders.
[42] Eight firms sponsor funds that invest in derivatives and other non-securities in reliance on exemptive orders, and five sponsor funds that invest in reliance on the *Northern Lights* no-action letter.
[43] Three firms.
[44] Seven firms.
[45] Eight firms.
[46] Three firms.
[47] Eight firms.
[48] The Survey asked respondents the purpose of making investments in acquired funds, and the reasons given were equitizing cash (seven firms), tactical asset allocation (seven firms), achieving investment objective (six firms), hedging exposures (three firms), providing short exposure (one firm), cash management (one firm), and minimizing asset turnover (one firm).

no-action letters, one respondent in reliance on Section 12(d)(1)(F), and one respondent in reliance on Rule 12d1-1.

Based on data gleaned from the Survey, as well as the experience of AMG members in operating funds of funds, we have concluded that a significant number of all existing fund of funds arrangements are likely to be directly impacted by the adoption of the Proposed Rule and the rescission of Rule 12d1-2 and existing Commission exemptions and related no-action letters. AMG does not believe that it was the Commission's intention to propose a rule that would prove disruptive to much of the fund of funds industry, but we fear that will be the unintended consequence of the adoption of the Proposed Rule and the rescission of Rule 12d1-2 and existing Section 12(d)(1) exemptions.

C. AMG's Comments on the Proposal

Although AMG is supportive of the rationale behind the Proposed Rule – to streamline and enhance the regulatory framework applicable to funds of funds and to create a consistent and efficient rules-based regime for the formation and oversight of funds of funds – we believe that aspects of the Proposed Rule will be needlessly disruptive to a fund of funds industry that is currently operating effectively. Despite the mélange of statutory provisions, rules, exemptive orders and no-action letters governing fund of funds arrangements today, the complex regulatory landscape has not resulted in disparate treatment of fund of funds issuers or, to our knowledge, in any problems with existing fund of funds structures that implicate investor protection concerns.[49]

The 3% Redemption Limit

The 3% Redemption Limit would be harmful to investors and it should be removed from the Proposed Rule. The limit differs significantly from current fund of funds requirements, and would cause significant disruption to existing fund of funds arrangements. Under current ETF exemptive orders, there is no comparable redemption limit. And with respect to percentage limits imposed under the Proposed Rule, we note that the mirror/pass-through voting provisions from the exemptive orders do not apply unless a fund owns more than 25% of an acquired fund, while under the Proposed Rule, the threshold is reduced to 3% of an acquired fund's shares. In addition, an entirely new 3% Redemption Limit has been added without a clear explanation.[50] This would present significant challenges for investments in acquired funds that are mutual funds, and would unfairly discriminate against registered investment companies since other investment vehicles and individual investors could redeem shares in the same acquired funds without restriction.

Portfolio Management Impacts. In managing funds, portfolio managers routinely make investment decisions that they think will enhance returns or reduce risk. With funds of funds, these decisions include whether to buy or sell shares of individual acquired funds depending on, among other factors, the portfolio managers' views regarding the relative risks and opportunities the acquired funds present. Further, funds engage in large scale redemptions for a number of benign reasons, including glidepath changes by target date funds, portfolio rebalancing, responding to market conditions or

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[49] We note that, although the Proposed Rule is intended to address the purposes of the 1970 amendments to Section 12(d)(1), the Commission has never cited any actual abuses that have occurred since the 1996 amendments were adopted. In addition, we believe that the Proposed Rule is inconsistent with the 1996 Congressional directive that the Commission interpret Section 12(d)(1) in a "progressive manner." *See* H.R. Rep. No. 104-622, *supra* note 11.

[50] The 3% Redemption Limit does not necessarily present any difficulties where a fund holds shares of an ETF or an exchange-listed closed-end fund since those shares can be freely sold in the secondary market.

changes in the acquired fund (*e.g.*, a portfolio manager or investment strategy change), redemptions in preparation for the liquidation or merger of the fund of funds itself, and, in severe cases, where the fund wants to exit the investment in an acquired fund in the case of fraud, bankruptcy, or other liquidity concerns about the acquired fund or its adviser.

Under the Proposed Rule, a fund of funds portfolio manager may no longer have the flexibility to manage the fund as he or she sees fit if the fund is limited in the amount of acquired fund shares it can redeem or if the fund changes the investments it makes to avoid being subject to the 3% Redemption Limit. Similarly, while the portfolio manager of a fund of funds relying on Section 12(d)(1)(G) may otherwise wish to make direct investments (for example, by purchasing a futures contract to hedge against interest rate risk or to equitize cash), the rescission of Rule 12d1-2 contemplated by the Proposal will take away that flexibility, meaning that the fund will either have to forego those investments or will have to instead operate under the Proposed Rule, becoming subject to the 3% Redemption Limit.

The practical challenges associated with the 3% Redemption Limit may also effectively prevent funds of funds from obtaining more precise exposures to a select group of acquired funds, which would limit the types of funds of funds available to investors, reducing investor choice. The Proposed Rule also would create incentives for funds of funds to select ETFs, exchange-listed CEFs and BDCs (which would not be subject to the 3% Redemption Limit) and larger mutual funds (which would allow larger investments by a fund of funds before the 3% Redemption Limit was triggered) as acquired funds, as opposed to smaller mutual funds, which would unfairly disadvantage those smaller funds.[51] To the extent that the Proposed Rule may drive acquiring funds to invest in ETFs, other exchange-traded products or larger mutual funds to avoid the 3% Redemption Limit, it also would further reduce investor choice and decrease portfolio management flexibility by tying portfolio managers' hands as to what they can invest in under the Proposed Rule.

Impact on Retail Investors and Target Date Funds. Further, retail investors investing in fund of funds arrangements may be unfairly disadvantaged by the Proposed Rule because their exposure to acquired funds through a fund of funds would be subject to the 3% Redemption Limit, while other investors who came in directly to an acquired fund would not be so limited and therefore would be able to access liquidity with priority over investors in funds of funds. In particular, the 3% Redemption Limit could negatively impact target date funds when they make scheduled portfolio changes pursuant to their stated glidepaths. Glidepath changes often involve significant portfolio rebalances as the target date fund reduces its equity fund holdings and increases its fixed income fund holdings over time.[52] If the implementation of a scheduled glidepath change is delayed due to the 3% Redemption Limit, the target date fund may experience adverse performance impacts, which would harm its investors.

Separate from glidepath considerations, we note that target date funds often have very large retirement plan shareholders, and the ability of a target date fund to liquidate some or all of its position in an

[51] Director Blass recently expressed concern about the impact of recent industry changes on the ability of small and medium-sized fund companies to compete, so the Proposed Rule should not contribute to these disadvantages. *See* Dalia Blass, Director, Division of Investment Management, Keynote Address: ICI Mutual Funds and Investment Management Conference (Mar. 19, 2019), *available at* https://www.sec.gov/news/speech/speech-blass-031819.

[52] The Proposed Rule may also encourage sponsors to establish collective investment trusts ("**CITs**"), which fall outside of the scope of SEC regulation. Instead, CITs are regulated by state or federal bank authorities, who are often focused on different issues than the Commission. Increasingly, CITs are utilized as target date retirement products due to perceived cost and regulatory advantages.

acquired fund to satisfy redemptions from these large plans may be disrupted by the 3% Redemption Limit.

Liquidity Risk Management Program Impacts. Being subject to the 3% Redemption Limit also may have implications for acquiring funds' liquidity risk management programs pursuant to Rule 22e-4 under the 1940 Act because certain acquired fund investments may be deemed illiquid to the extent they exceed 3% of an acquired fund's assets.[53] To avoid being subject to the 3% Redemption Limit and having such investments deemed illiquid, funds may have to reduce their investments in individual acquired funds and allocate their investments across a broader array of acquired funds or other investments (which may be difficult for affiliated funds of funds that are part of fund families offering relatively few funds) or in non-investment company securities or other instruments. However, forcing funds to diversify their fund holdings will limit portfolio management flexibility and may result in investments in funds or other investments that are less optimal given the fund's investment goals, and may impair an adviser's ability to fulfill its fiduciary obligations to the funds.

Impacts on Acquiring Funds. The 3% Redemption Limit could also impact the ability of <u>an acquiring fund</u> to satisfy redemption requests from its own investors. For example, if an acquiring fund that holds more than 3% of an acquired fund's shares faces significant redemptions, it may seek to redeem more than 3% of that acquired fund's shares to satisfy those redemptions, but may be unable to do so due to the 3% Redemption Limit. Moreover, to the extent other investors in the same acquired fund are able to redeem their acquired fund shares ahead of a fund of funds that is subject to the 3% Redemption Limit, the fund of funds may hold an increasingly large (and illiquid) position in the acquired fund. This is especially true if there is an event causing a rush to redeem an individual acquired fund's shares (such as a portfolio manager change), where other investors are able to redeem shares freely but the acquiring fund is not. In addition, the 3% Redemption Limit could force a fund of funds to remain invested in an acquired fund that is no longer appropriate for it (for example, because the acquired fund has had a strategy change or a portfolio manager change or is proposing to merge or liquidate), even when the acquired fund is highly liquid (*e.g.*, a government bond fund).

Impact on AMG Members. The 3% Redemption Limit will have significant real world impacts for AMG members. AMG's Survey results indicate that hundreds of AMG members' funds of funds own more than 3% of a single acquired fund, and those funds redeem 3% or more of an acquired fund's shares more frequently than suggested in the Proposing Release.[54] Survey respondents indicated that there have been more than 500 circumstances where acquiring funds have redeemed more than 3% of an acquired fund's shares in a single redemption since the beginning of 2018. Given the number of redemptions exceeding 3% of an acquired fund's shares on a single day, it is safe to assume that the number of redemptions exceeding 3% over any 30 days is higher. Therefore, we believe many funds of funds will be induced to restructure their portfolios either to limit the potential impact of the

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[53] Under Rule 22e-4(a)(8), an "illiquid investment" means any investment that the fund reasonably expects cannot be sold or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment. Because the 3% Redemption Limit would prevent an acquiring fund that holds more than 3% of the total outstanding shares of an acquired company from redeeming more than 3% of the acquired fund's total outstanding shares during any 30-day period, the acquiring fund's holdings of the acquired fund in excess of 3% of the acquired fund's total outstanding shares would not be able to be "sold or disposed . . . in seven calendar days or less." As a result, such holdings may be deemed illiquid and may count against the 15% limit on the acquiring fund's investments in "illiquid investments" under Rule 22e-4(b)(iv).

[54] *See* Proposing Release, *supra* note 2, at 50, note 125.

3% Redemption Limit (by limiting investments in acquired funds) or to fall outside of the Proposed Rule altogether (for affiliated funds of funds, by relying exclusively on Section 12(d)(1)(G)), in either case to the potential detriment of investors.[55]

Affiliated Funds of Funds. The application of the 3% Redemption Limit to funds currently relying on Section 12(d)(1)(G) makes little sense, even if those arrangements include direct investments in securities and/or non-securities such as derivatives. In cases where funds in such an arrangement share a common investment adviser, the adviser owes fiduciary duties to both the acquiring fund and the acquired fund, and there is little risk of overreach or undue influence. Even where the advisers to the acquiring fund and acquired fund are control affiliates, we believe the risks are minimal. Indeed, the Commission specifically acknowledged this by exempting affiliated funds of funds from the voting and control conditions of the Proposed Rule,[56] stating that "in cases where the arrangement involves funds that are advised by advisers that are control affiliates, we do not believe that the acquiring fund adviser generally would seek to benefit the acquiring fund at the expense of the acquired fund (nor do we believe that the acquiring fund would seek to influence the acquired fund through its ownership interest in the acquired fund)."[57] We believe that, if fiduciary duty considerations offer sufficient protection from undue influence to obviate the need for an affiliated fund of funds to surrender its voting rights (*i.e.*, through mirror or pass-through voting) or to be subject to limitations on their ability to control funds through ownership of >25% of a fund's shares, they should also be sufficient to mitigate the risks of undue influence associated with such a fund redeeming more than 3% of an affiliated acquired fund's shares.[58]

Potential Alternatives to the 3% Redemption Limit

Rule Provisions that Require Unaffiliated Acquiring Funds to Comply with Various Limitations

AMG believes that the current participation agreement regime utilized by most unaffiliated funds of funds is functioning well and effectively addresses the potential for overreach, undue influence and other concerns identified by the Commission in its 1966 Public Policy Implications Report.[59] AMG is unaware of any obvious problems with fund of funds participation arrangements to date. However, since participation agreements can be administratively burdensome, AMG is proposing to replace participation agreements with a rules-based regime that addresses many of the same concerns.

In lieu of the 3% Redemption Limit, AMG believes that the Commission could adopt a rules-based approach that requires acquiring funds in unaffiliated fund of funds arrangements and their advisers:

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[55] The 3% Redemption Limit may also impact innovation in the funds space to the extent that the development and use of future mechanisms to move assets between underlying funds may be limited.

[56] *Id.* at 38 ("The proposed exceptions are designed to include arrangements that are permissible under section 12(d)(1)(G) and our exemptive orders within the regulatory framework of rule 12d1-4. Based on our experience overseeing fund of funds arrangements, we believe the proposed exceptions are appropriately tailored to except only those fund of funds arrangements that do not raise the concerns of undue influence that underlie section 12(d)(1) from the control and voting conditions.")

[57] *Id.* at 41.

[58] With the proposed rescission of Rule 12d1-2, a Section 12(d)(1)(G) funds of funds will become subject to the 3% Redemption Limit if it buys a single security or derivative.

[59] Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H.Rep. No. 2337, 89th Cong., 2d Sess. (1966) (the "**PPI Report**").

(i) to operate their funds in the best interest of the acquiring funds, including with respect to investing in an acquired fund,

(ii) to make a representation with respect to each acquired fund that it invests in that the acquiring fund will not exercise undue influence or otherwise overreach with respect to the acquired fund, will not take into account the compensation received by the acquiring fund or its affiliates in deciding to make an investment in the acquired fund, and will not seek to exercise actual control over the acquired fund, and

(iii) to establish compliance policies and procedures for investments beyond the Section 12(d)(1)(A) and (B) limits made in reliance on the Proposed Rule.

Best Interest Standard. AMG's proposed "best interest" standard is similar to the requirement in the Proposed Rule that the acquiring fund's adviser determine that it is in the best interest of the acquiring fund to invest in the unaffiliated acquired fund.[60] The "best interest" determination could be expanded to other aspects of the decision to design and operate unaffiliated funds of funds, including the decision to establish a multi-tier fund of funds structure or to utilize a central funds structure, where appropriate, in addition to the decision to invest in a particular acquired fund. Under AMG's proposal, the acquiring fund's best interest decision should take into account not only the fees, complexity and investment characteristics of each acquired fund it invests in, but also other relevant factors, such as the acquired fund's size, underlying asset liquidity, level of asset volatility, legal structure and other characteristics.[61]

Policies and Procedures. In addition, the Proposed Rule could require the acquiring fund to adopt policies and procedures overseen by the acquiring fund's adviser[62] that would seek to ensure that the acquiring fund operates in accordance with the best interest standard described above. In addition, the policies and procedures would also require certain standard representations from the adviser to the effect that, when investing in an acquired fund, the acquiring fund:

- will not seek to exercise control over the acquired fund;
- will mirror vote or pass through the vote on its shares of the acquired fund;
- will not take into account the consideration or compensation received by itself or its affiliates in determining to invest in the acquired fund and that any compensation received by the acquiring fund or its affiliates will be fair and reasonable relative to the services provided and that the services provided will be of a similar nature and quality as those available from other parties; and
- will not seek to exert undue influence over or otherwise overreach the acquired fund, including through the threat of large scale redemptions.

[60] Under AMG's proposal, these provisions would not apply to determinations to invest in affiliated funds since the affiliated adviser would have fiduciary duties both to the acquiring fund and the acquired fund.
[61] With respect to the Commission's best interest proposal, to the extent AMG's proposed approach is not adopted, AMG also asks that the Commission clarify that "closed architecture" fund of funds programs that limit their investments in funds to those within a specified group of investment companies would not be required to compare such investments to funds outside the applicable investment universe.
[62] These policies and procedures could, but need not be required to, be adopted by the acquiring fund's board pursuant to the requirements of Rule 38a-1 under the 1940 Act.

These conditions could be tied into a requirement that the adviser initially determine that making an investment in a particular unaffiliated acquired fund is in the acquiring fund's best interest.[63] The adviser would be responsible for documenting each determination and reviewing these determinations and presenting the results of these reviews to the board of the acquiring fund at least annually.

Adviser Oversight. The adviser to an acquiring fund, rather than the acquiring fund's board, should be the party primarily responsible for entering into and monitoring fund of funds arrangements. As noted in the Proposed Rule with respect to decisions to invest in acquired funds, the adviser's determination to purchase shares of another fund would be subject to periodic board oversight and review. Involving the board before the fact in making decisions on which acquired funds to invest in is inconsistent with the view that the adviser, in the exercise of its fiduciary duties in managing the acquiring fund, should be responsible for evaluating and selecting investments. Moreover, involving the board *ex ante* in these investment decisions is at odds with the Commission's recent efforts to better calibrate the role of the board relative to the role of the adviser. Having the board review determinations after the fact is consistent with its traditional oversight role, and properly empowers and obligates the adviser to make portfolio management decisions in the best interest of the acquiring funds.

This best interest framework should apply only to fund of funds that invest in unaffiliated funds. With affiliated fund of funds, as noted above, the common adviser is subject to a fiduciary duty to both funds and is well positioned to protect the interests of both the acquiring and acquired funds and has little incentive to disadvantage an acquired fund at the expense of an acquiring fund.

Conclusion. AMG strongly believes that the 3% Redemption Limit is harmful to funds of funds and their investors, and should be removed. The 3% Redemption Limit is even more problematic for affiliated funds of funds where there are currently no such limits and with respect to which the Commission has expressly acknowledged that there is substantially reduced risk of overreach by the acquiring fund.

Voting and Control Provisions

While AMG does not believe the voting and control provisions of the Proposed Rule are necessary (including in the context of AMG's proposal for a rules-based framework), we do not object to a requirement to mirror vote or pass-through vote where an acquiring fund owns more than a certain percentage of an acquired fund's outstanding shares. However, we do not believe that the Proposed Rule's voting provisions should be triggered at 3% of an acquired fund's outstanding shares, especially since under existing fund of funds relief that is widely available, similar voting provisions are not triggered until an acquiring fund owns 25% or more of an acquired fund's outstanding shares.

In addition, we fear that the Proposed Rule's voting conditions may have the unintended effect of increasing the influence of activist firms over targeted CEFs. The Proposed Rule requires that an acquiring fund and its advisory group that collectively hold more than 3% of an acquired fund utilize mirror or pass-through voting. AMG has observed that activist firms are utilizing multiple private funds to acquire significant positions in CEFs, but such private funds would not be subject to the Proposed Rule. In contrast, registered funds investing in CEFs would be subject to this voting

[63] This proposed approach is similar to the approach detailed in proposed Rule 6c-11 under the 1940 Act, where the adviser to an ETF must determine that entering into a custom basket transaction is in the best interest of the ETF and each such determination must be documented and reviewed by the adviser.

condition. Therefore, such registered funds would likely mirror vote shares held in any CEF subject to the voting condition. This would have the effect of increasing the voting power of activist firms, thus rewarding such firms for their bad behavior in structuring multiple private funds to skirt ownership limitations We believe the Commission could mitigate this concern by increasing the percentage beyond which an acquiring fund and its advisory group are required to mirror or pass-through vote. The current 3% threshold is low, and it is difficult to understand how an acquiring fund and its advisory group could exercise outsized influence when holding such a small percentage of an acquired fund's shares. We recommend that the voting condition's threshold be increased to a level at which it is more reasonable for the Commission to be concerned about undue influence. Moreover, increasing the threshold would allow acquiring funds to hold larger positions in CEFs without forfeiting the right to exercise their independent judgment regarding shareholder proposals.

Since the voting and control provisions do not create significant operational challenges for funds and since they may prove to be an unobtrusive means to address some of Congress's concerns relating to voting control that are set forth in the Proposal, AMG would not object if they are adopted subject to the changes recommended above.[64]

Rescission of Rule 12d1-2

If the Proposal is adopted, there will essentially be two choices facing affiliated fund of funds – continue to operate under Section 12(d)(1)(G), but without the flexibility offered by Rule 12d1-2 and the *Northern Lights* no-action letter (or similar exemptions), or operate under Rule 12d1-4 with flexibility to invest in securities of unaffiliated investment companies, securities of non-investment companies and other instruments, but also be subject to the 3% Redemption Limit. As noted above, we believe that forcing affiliated funds of funds to make this choice will harm investors by reducing investment flexibility and potentially lowering returns. To avoid this result, the Commission should either include an exemption under the Proposed Rule from the 3% Redemption Limit for affiliated funds of funds or retain Rule 12d1-2 for funds relying on Section 12(d)(1)(G). Either of these approaches would provide affiliated funds of funds with the flexibility to invest in non-investment company securities, money market funds, and, to a limited extent, unaffiliated funds. In fact, AMG believes that the Commission should expand Rule 12d1-2 to permit Section 12(d)(1)(G) funds to invest in non-securities[65] (such as futures contracts) consistent with the terms of the *Northern Lights* no-action letter.

To better align the Rules under Section 12(d)(1), the Commission could add a requirement to Rule 12d1-2 that an adviser making investments in unaffiliated funds pursuant to the Rule must determine that making such investments is in the best interest of the acquiring fund. Our proposal would allow

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[64] Most open-end funds, ETFs and UITs do not hold regular shareholder meetings, so the Proposed Rule's impact will largely be limited to CEFs and BDCs. However, the Proposed Rule should not create an opportunity for activist investors to use foreign and private funds to attempt to take over the management of CEFs and BDCs by using multiple entities that own less than 3% in an acquired CEF or BDC.

[65] This proposed expansion to include non-securities is consistent with a 2008 Commission proposal, which would have amended Rule 12d1-2 to permit Section 12(d)(1)(G) funds to invest in non-securities, including derivatives. See 2008 Proposing Release, *supra* note 3. AMG is unaware of any problems experienced by Section 12(d)(1)(G) funds that would have caused the Commission to propose more restrictive limits at this time. Indeed, it is unclear why an investment in securities or non-securities by an affiliated fund of funds would cause such fund of funds to have to make a "best interest" determination to make investments in other funds when there is no similar requirement imposed on other types of funds of funds when they invest in such funds and instruments.

all affiliated funds of funds currently relying on Section 12(d)(1)(G) to avoid having to operate under Rule 12d1-4, so even if the Commission determined to implement the 3% Redemption Limit for other types of funds of funds, Section 12(d)(1)(G) funds would appropriately fall outside the Proposed Rule given that they do not raise the same concerns regarding the potential exercise of undue influence over unaffiliated acquired funds. As noted previously, in adopting Section 12(d)(1)(G), Congress did not see a need to include restrictions on a fund's ability to redeem shares of affiliated funds. Further, the Proposed Rule ignores Congress's suggestion that the Commission use its authority "in a progressive way."[66]

Affiliated funds of funds should be permitted to continue to operate within the existing framework that has been developed under Section 12(d)(1)(G), Rule 12d1-2, and existing no-action letters. Rescission of Rule 12d1-2 will cause many affiliated funds of funds to alter how they operate. Making changes to existing affiliated fund of funds arrangements may adversely impact existing shareholders, including if acquiring funds redeem positions in existing acquired funds that they believed were in the best interests of the fund to hold in order to come below the 3% limit prior to the implementation of the Proposed Rule to avoid liquidity issues. These redemptions could also require portfolio restructuring, which may result in higher transaction and market impact costs and have unanticipated tax consequences for fund shareholders. In addition, funds of funds that are compelled to restructure will face a significant (and expensive) shareholder communication effort. At the very least, funds of funds will have to implement and explain significant portfolio repositionings required by the Proposed Rule, as well as any performance impacts of these portfolio repositionings.

Rescinding 12(d)(1)(A), (B), (C) and (G) Orders and No-Action Letters; Complexity

Many fund complexes have fund of funds arrangements that rely in part on custom Section 12(d)(1) exemptions that would be rescinded under the Proposal. Rescission of these exemptions in connection with the Proposal's "one size fits all" approach would cause many fund of funds sponsors to have to modify highly tailored and well-functioning fund of funds products, resulting in significant disruption. These exemptions were originally sought as means to provide enhanced returns to investors, so their rescission will have a direct, detrimental impact on investors. Unless the Proposal is modified to permit the types of arrangements currently permitted by the exemptions (and related no-action letters), these exemptions and letters should not be rescinded.

Central Funds. It is unclear if the rescission of Section 12(d)(1) exemptive orders contemplated by the Proposal would impact the use of central funds, including securities lending cash collateral arrangements and other arrangements that are not technically funds of funds. AMG believes that the *Thrivent* and *Franklin Templeton* no-action letters represent "progressive" steps taken by the Commission to encourage fund of funds arrangements, and notes that many existing fund of funds arrangements incorporate these efficient and cost-effective central funds. Accordingly, AMG recommends that the Commission retain or consider codifying existing central fund no-action relief.

Existing exemptive orders and the *Thrivent* no-action letter permit cash management arrangements so long as the investing fund does not invest more than 25% of its assets in underlying short-term funds. While the text of the Proposing Release notes that central funds could continue to be used for short-term cash management purposes under the Proposed Rule, there is no mention in the Proposing Release of restricting the use of central funds for cash management purposes beyond what is permitted

[66] *See* H.R. Rep. No. 104-622, *supra* note 11, at 44-45.

currently. In the Proposed Rule, the use of central funds for cash management purposes other than pursuant to Rule 12d1-1 is permitted only if pursuant to an exemptive order. However, all Section 12(d)(1) exemptive orders other than for interfund lending and borrowing would be rescinded under the Proposal, and not all exemptive orders for short-term cash management are contained in such interfund lending orders. It is unclear why a rule that is intended to simplify the rules around funds of funds would require a new exemptive order to continue cash management fund operations when such conditions could instead be incorporated directly into the Proposed Rule. Such a change would have a significant impact since many fund firms use central funds extensively for cash management. If these funds were instead limited to investing only in money market funds, such limitation would adversely impact the yield that funds could generate on their central cash management investments, with no identified investor protection benefit.

The *Franklin*/*Thrivent* line of no-action letters permits central funds other than for cash management purposes where there is a 10% limit that applies to the acquiring fund (and aggregates more broadly with other investment companies and 3(c)(1)/3(c)(7) funds). AMG sees no reason for applying different limits to similar transactions – all such arrangements should be permitted without limit, particularly if they involve affiliated funds and there is no duplication of fees or potential for overreach. As with existing Section 12(d)(1) exemptions, these letters permit various arrangements designed to benefit fund investors through higher returns and/or lower costs. The same arguments for permitting central cash management funds exist for other types of central funds – cost savings and reduced operational risk, diversification and efficiency – apply equally to other asset classes where scale can lead to improved results for investors.

Other Relief. Similarly, relief relating to investments in affiliated private central funds (*e.g.*, the TIAA order and the *Nicholas-Applegate* no-action letter)[67] and relief permitting affiliated foreign funds to invest in U.S.-registered investment companies beyond the limits of 12(d)(1)(A), (B) and (C) (*e.g.*, the *Dechert*[68] no-action letter) should not be rescinded as they provide additional flexibility in structuring fund of funds.

Complexity. AMG believes that, if an adviser, acting as a fiduciary, can make a determination that investing in an acquired fund is in the acquiring fund's best interest, the adviser should also be able to make a determination that utilizing central funds for cash management or other legitimate investment purposes, relying on the relief previously provided for by the Commission and its staff in various no-action letters, or utilizing multi-tier structures is appropriate and in the acquiring fund's best interest.

In particular, AMG recommends that multi-tier fund of funds arrangements should be permitted subject to the adviser's determination that the structure is in the best interest of the acquiring fund. There are numerous reasons to use multi-tier structures that do not implicate the public policy concerns articulated in the PPI Report (as modified by the 1996 amendments to Section 12(d)(1)).

[67] *See*, *e.g.*, TIAA-CREF Funds, et al., Investment Company Act Release Nos. 31807 (Sept. 8, 2015) (notice) and 31861 (Oct. 6, 2015) (order); *Nicholas Applegate Capital Management*, Staff No-Action Letter (pub. avail. Feb. 7, 1997).

[68] *See* the *Dechert* no-action letter, *supra* note 18. Under this letter, a foreign fund must comply with 12(d)(1)(A)(i), which protects the acquired fund's shareholders (who are U.S. shareholders when a foreign fund is investing in a U.S. fund in reliance on the letter). The foreign fund need not comply with Sections 12(d)(1)(A)(ii) and (iii), which protect the acquiring fund and its shareholders. Because the acquiring fund is foreign, this should be outside of the scope of the Commission's regulatory interests in advancing the Proposal. *See also Dechert LLP*, Staff No-Action Letter (pub. avail. Mar. 8, 2017).

These arrangements provide additional portfolio management flexibility, efficiency and cost-effectiveness without the potential for exerting undue influence or otherwise overreaching the acquired funds. Any such best interest determinations made by the adviser should be documented and reported pursuant to the terms of the acquiring fund's policies and procedures (as detailed above).

Clarification Regarding Certain Structures. The Commission should clarify that collateralized debt obligations, collateralized loan obligations and similar structures that rely on Section 3(c)(7) would not be subject to the limits on investing in 3(c)(1)/3(c)(7) Funds. AMG believes that this is appropriate, since existing Commission staff guidance excludes such structures from the requirement to disclose them in the prospectus fee table as part of acquired fund fees and expenses ("**AFFE**").

Other Issues

Foreign and Private Funds. AMG asks the Commission to consider extending the availability of the Proposed Rule to private and foreign funds that invest in U.S.-registered investment companies and BDCs. These funds, while not necessarily subject to complete Commission oversight, could nevertheless be subject to Commission jurisdiction. For example, potential jurisdictional connections could include private or foreign funds that (a) execute a participation agreement with a U.S. fund of funds, (b) are advised by a U.S.-registered investment adviser or (c) are otherwise subject to requirements to report their investments in U.S. funds.

However, if the Proposed Rule is expanded to include foreign and private funds, we suggest, as noted above, that the Proposed Rule be revised to subject private and foreign fund investments in CEFs and BDCs to the same restrictions that apply in Section 12(d)(1)(C) to prevent activist shareholders from developing multiple structures designed to avoid applicable investment limits.[69]

Advisory Group Definition. AMG believes that the Commission should revise the definition of "advisory group" in the Proposed Rule to ensure that affiliated parties that are subject to strict information barriers and that are not subject to actual common control or management are not considered to be part of the same "advisory group."[70] In most cases, firms that are technically affiliates under the 1940 Act do not share information on current investments with their affiliates. AMG believes that where there is no opportunity for coordination of action or investment, these affiliates should not be considered part of the same "advisory group." In addition, where there is complete independence and separation of decision-making, there is no ability to coordinate investments for purposes of exercising control over or otherwise influencing an acquired fund. Likewise, decisions to invest in acquired funds will be subject to each adviser's best interest determination requirement, which should preclude coordination with other firms.

Disclosure. The Proposed Rule's requirement that an acquiring fund disclose in its registration statement that it is (or "at times may be") an acquiring fund is not practical. It will be challenging for acquiring funds to search potential acquired fund prospectuses to determine whether such funds will likely be acquiring funds themselves. Further, there is a risk that potential acquired funds will

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[69] AMG understands that activist firms have taken advantage of an inadequate statutory framework to hold shares of CEFs well in excess of the limits in Sections 12(d)(1)(A)(i) and 12(d)(1)(C), and we urge the Commission to work with Congress to address this issue. We believe that the Proposal's voting conditions may have the unintended effect of increasing the influence of activist firms, and we ask the Commission to consider making changes to mitigate this concern.

[70] *See*, for example, Rule 2a-6 under the 1940 Act: A transaction that does not result in a change of "actual control or management" of the investment adviser is not deemed an assignment for purposes of the 1940 Act.

prophylactically indicate that they may rely upon the Proposed Rule, which will limit the investable universe of underlying funds, reduce investor choice and create significant administrative burdens.[71]

Acquired Fund Fees and Expenses. AMG believes that AFFE disclosures should better distinguish between items that represent operating expenses from those that represent investment expenses. We support eliminating the need to include certain investment-related expenses in fee tables in the prospectus (not just for BDCs and CEF, but for all of the types of investment companies covered by the Proposed Rule).

A similar issue was recently addressed in a recent comment letter relating to Commission questions on the investor experience.[72] We agree with the commenter that fee disclosures should better distinguish between items that represent true operating expenses and those that represent investment expenses, and we support eliminating the need to include certain investment-related AFFE expenses in fee tables. Including investment-related expenses in the fee table is confusing and misleading to investors, and the Commission should change the AFFE disclosure requirements to prevent these outcomes.

In light of the ongoing discussion of AFFE and its appropriateness in the fee table, we believe that the fund fee table is intended to illustrate to investors the "expenses that [investors] pay each year as a percentage of the value of [their] investment."[73] While many traditional components of the "other expenses" line item (*e.g.*, audit, legal, custody, and transfer agency fees) are often predictable operating costs that normally do not vary significantly from year to year, interest expense is more akin to a portfolio transaction cost in that it lacks the same predictability year to year. In contrast, AFFE, interest expense and other portfolio transaction costs (such as brokerage commissions) are largely driven by a fund's investment strategies and techniques, which may vary significantly from year to year in response to changing market conditions.

In AMG's view, there is no practical reason that AFFE and interest expense should be treated differently from other types of portfolio transaction costs for disclosure purposes (which are not required to be disclosed in the fee table), and we believe that such treatment provides investors with an incomplete and potentially misleading picture of the costs and benefits of a particular fund's investment strategy.

In our experience, funds implementing fixed income investment strategies often incur interest expense from certain financing transactions (*e.g.*, reverse repurchase agreements) to generate additional returns for the fund net of interest expense. Without the appropriate context, an investor cannot know that a fund incurs this interest expense solely in the pursuit of additional returns, and that the returns of the strategy, net of interest expense, are intended to be positive, particularly as compared to alternative strategies that do not generate interest expense. Consistent with this general approach to informing investors that they may bear other types of fees and expenses outside of those enumerated in the fee table, interest expense should be omitted from the AFFE in the table like all other portfolio transaction expenses.

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[71] Alternatively, if a participation agreement framework is maintained, the participation agreement could set forth the list of relevant funds that are expected to be acquiring funds.

[72] Comments of the Investment Company Institute, *available at* https://www.sec.gov/comments/s7-12-18/s71218-4932121-178430.pdf.

[73] Item 3 of Form N-1A.

Finally, we note that certain similar economic transactions receive different accounting treatment regarding whether interest expense is reported. For example, a hypothetical fund ("Fund 1") may use an instrument that generates interest expense, while another hypothetical fund ("Fund 2") may use a less efficient and/or more costly instrument that does not generate interest expense but provides Fund 2 with the same economic exposure as Fund 1. Given that Fund 1 must report the interest expense associated with its investment in the fee table, an investor may incorrectly believe that Fund 1 is more expensive and choose to invest in Fund 2 simply because Fund 2 discloses a lower total expense ratio, all else being equal. We believe that excluding interest expense from the fee table will reduce investor confusion and avoid misleading investors regarding their ongoing costs of owning a fund.

Section 17. AMG is seeking additional clarity regarding the discussion of Section 17 of the 1940 Act in the Proposing Release.[74] Existing lore regarding whether Section 17 is applicable to fund of funds investments is unclear and inconsistent. AMG recommends that the Commission indicate that if a fund engages in fund of funds investments or redemptions in reliance on the Proposed Rule or within the limits of, or in reliance on, Section 12(d)(1)(A), (B), (C), (E), (F) or (G), Section 17(a) and Section 17(d)/Rule 17d-1 concerns would not be implicated. We believe this is a logical result since it would be odd for a transaction that is expressly permitted by statute and related rules within specified limits to be restricted or prohibited by another section of the statute or in related rules. Moreover, this treatment would be consistent with existing Commission staff guidance on Section 12(d)(1)(G) and Section 17, and should be applicable to all transactions under Section 12(d)(1) noted above.

D. <u>Conclusion</u>

AMG's comments and suggestions on the Proposal are designed to assist the Commission in improving the Proposal in order to avoid some of the Proposal's inadvertent yet disruptive impacts. We believe that the 3% Redemption Limit should be removed, but if the Commission believes that it must establish explicit rules, we suggest the Commission adopt a rules-based best interest framework for unaffiliated funds of funds. We also believe that Rule 12d1-2 and various exemptions under Sections 12(d)(1)(A), (B), (C) and (G) and related no-action letters should not be rescinded. Instead, these items should be codified in the Proposed Rule so that existing funds of funds will not be forced to choose between complying with a needlessly restrictive redemption limit or restructuring well-established and well-functioning funds of funds to avoid this redemption limit.

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[74] *See* Proposing Release, *supra* note 2, at 26-30.

AMG sincerely appreciates the opportunity to comment and your consideration of these views. We stand ready to provide any additional information or assistance that the Commission might find useful. Please do not hesitate to contact either Timothy Cameron at [redacted] ([redacted]) or Lindsey Keljo at [redacted] ([redacted]), or our outside counsel, Edward Baer, Ropes & Gray LLP, at [redacted] ([redacted]), with any questions.

Sincerely,

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Asset Management Group – Head

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Asset Management Group – Managing
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Securities Industry and Financial
Markets Association

cc: Honorable Jay Clayton, Chairman, U.S. Securities and Exchange Commission
Honorable Hester M. Peirce, Commissioner, U.S. Securities and Exchange Commission
Honorable Robert J. Jackson, Jr., Commissioner, U.S. Securities and Exchange Commission
Honorable Elad L. Roisman, Commissioner, U.S. Securities and Exchange Commission
Ms. Dalia Blass, Director, Division of Investment Management, U.S. Securities and Exchange Commission