

May 2, 2019

**VIA E-MAIL**

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

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

Dear Ms. Countryman:

This letter presents the comments of John Hancock Advisers, LLC and John Hancock Investment Management Services, LLC (collectively, “**John Hancock Investments**”) with respect to the proposal by the U.S. Securities and Exchange Commission (the “**SEC**” or “**Commission**”) to adopt new Rule 12d1-4 under Section 12 of the Investment Company Act, as amended (the “**1940 Act**”) (the “**Proposed Rule**”) and related changes, including the proposed rescission of Rule 12d1-2 under Section 12 of the 1940 Act and the various exemptive orders providing relief from Sections 12(d)(1)(A), (B), (C), and (G) of the 1940 Act (collectively, the “**Section 12(d)(1) Orders**”) (the Proposed Rule together with related changes, the “**Proposal**”). John Hancock Investments is a premier asset manager representing one of America’s most trusted brands, with a heritage of financial stewardship dating back to 1862. We provide investment management services to the John Hancock Group of Funds, a family of 215 registered funds, including 55 funds of funds, with approximately \$141.2 billion and \$72.8 billion in assets, respectively.<sup>1</sup> The funds of funds that we currently manage include funds that invest in affiliated underlying funds (“**funds of affiliated funds**”), funds that invest in unaffiliated underlying funds (“**funds of unaffiliated funds**”), and funds that invest in both affiliated and unaffiliated underlying funds (“**open-architecture funds of funds**”). Moreover, John Hancock funds of funds retain the flexibility to invest in both affiliated and unaffiliated underlying funds in order to best achieve their investment objective. This position affords us a broad perspective and insight into the management and operation of funds of funds.

We appreciate the opportunity to comment on the Proposal, and we commend the Commission’s efforts to improve and streamline the regulatory framework for funds of funds. In particular, we support the Commission’s desire to create a comprehensive and consistent framework for fund of funds investments and to expand upon the types of funds that can be part of fund of funds arrangements. However, we have significant concerns with certain aspects of the Proposed Rule,

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<sup>1</sup> Information regarding the John Hancock Group of Funds is as of December 31, 2018.

including Rule 12d1-4(b)(2), which prohibits a fund that holds more than 3% of an underlying fund's total outstanding shares from redeeming more than 3% of the underlying fund's total outstanding shares in any 30-day period (the "**Limited Redemption Provision**"). We believe the Limited Redemption Provision: (1) is unnecessary and highly disruptive to existing fund of funds arrangements, (2) has negative unintended consequences for shareholders, and (3) should be eliminated from the Proposed Rule. In addition, in light of the Limited Redemption Provision, we have concerns regarding the proposed rescission of Rule 12d1-2 and the Section 12(d)(1) Orders and the impact that the proposed rescission would have on existing funds of funds and their investors.

The balance of this comment letter is organized into five sections:

- I. an executive summary of our comments and proposals;
- II. a discussion of the benefits of funds of funds to their investors;
- III. a discussion of our concerns regarding the Limited Redemption Provision and other components of the Proposed Rule, and our proposals to address these concerns;
- IV. a discussion of our concerns regarding the proposed rescission of Rule 12d1-2 and the Section 12(d)(1) Orders, related structural concerns, and our proposals to address these concerns; and
- V. concluding thoughts.

## **I. Executive Summary**

We believe that funds of funds, particularly open-architecture funds of funds, offer numerous benefits to retirement investors. We therefore believe it is important that the Proposal facilitate, rather than deter, the use of fund of funds arrangements. As drafted, we believe that the Proposal would eliminate many of the benefits offered to shareholders by existing funds of funds, significantly disadvantaging fund of funds shareholders relative to other direct shareholders of an underlying fund, and significantly reducing the viability of certain types of fund of funds structures that are disadvantaged under the Proposal. In particular, we believe that the Limited Redemption Provision would harm shareholders of funds of funds by: (1) interfering with a fund of funds' ability to effectively pursue its investment objective and implement its investment strategies, (2) hindering the process of repositioning a fund of funds' portfolio, and (3) limiting a fund of funds' ability to redeem investments in an underlying fund at times when other direct investors in the same underlying fund are not so limited (thereby creating unnecessary liquidity risk). We also believe that the Limited Redemption Provision may create an incentive for managers to favor investments in exchange-traded products, affiliated underlying funds, and larger underlying funds, which could limit the universe of underlying funds and result in less diversity and fewer choices for investors.

For these reasons, we propose that the Commission eliminate the Limited Redemption Provision from the Proposed Rule and instead incorporate measures that would protect investors and achieve the same results, including by effectively codifying certain additional conditions from existing Section 12(d)(1) Orders. These conditions would address the policy concerns articulated by the Commission with respect to the exercise of undue influence over unaffiliated underlying funds and would contribute to a framework that would facilitate funds of funds investing without

raising the issues associated with the Limited Redemption Provision. Although we believe a codification of existing conditions is the least disruptive approach, we alternatively propose, in lieu of the Limited Redemption Provision, the implementation of limits above which funds of funds would no longer be able to purchase shares of unaffiliated underlying funds. In the event that the Limited Redemption Provision is not eliminated, we alternatively suggest several modifications that would alleviate certain concerns with the provision and propose a number of exceptions to the application of the Limited Redemption Provision, particularly in specific situations in which redemptions are necessary to avoid harm to investors.

Without the elimination of the Limited Redemption Provision, we also are concerned about the proposed rescission of Rule 12d1-2 and the Section 12(d)(1) Orders, which we believe would adversely impact existing funds of funds and their shareholders in several ways. For example, given the proposed rescission of Rule 12d1-2, funds of affiliated funds currently investing in reliance on Section 12(d)(1)(G) would no longer be able to invest in unaffiliated funds and direct (non-fund) instruments without relying on the Proposed Rule, which would subject them to the Limited Redemption Provision and may render those arrangements unworkable. We expect that many existing funds of affiliated funds would require significant restructuring of their portfolios in order to adjust for either the rescission of Rule 12d1-2 (for those intending to rely on Section 12(d)(1)(G)) or the Limited Redemption Provision (for those intending to rely on the Proposed Rule). Open-architecture funds of funds and funds of unaffiliated funds, unlike funds of affiliated funds, would have no choice but to become subject to the Limited Redemption Provision. We believe that this aspect of the Proposed Rule limits the investment flexibility of funds of funds and unnecessarily disadvantages open-architecture funds of funds and funds of unaffiliated funds.

## **II. Benefits of Fund of Funds Investments**

Funds of funds represent a large segment of the asset management market.<sup>2</sup> These types of arrangements are particularly popular among retail investors and often are used in retirement products. Target date funds, for example, account for about half of the investments in funds of funds.<sup>3</sup> Portfolio managers adjust allocations of target date funds among asset classes over time to provide for an appropriate risk/return profile as the fund approaches a particular target date, usually near the shareholder's anticipated retirement date. These products provide a simple way for retail shareholders to increasingly emphasize capital preservation and income.

Among the numerous important benefits offered by funds of funds, shareholders are able to efficiently and conveniently gain exposure to a variety of underlying funds, strategies, markets, and asset classes, which may diversify their investment exposures and associated risks and reduce portfolio volatility. Fund of funds shareholders also benefit from the expertise of the fund of funds' manager in selecting, overseeing, and managing exposure to underlying funds and in creating and maintaining an overall portfolio with a risk/return profile consistent with

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<sup>2</sup> As of the end of 2017, there were over 1,400 funds of funds, representing approximately \$2.2 trillion in assets. *See* Investment Company Institute, 2018 Investment Company Fact Book (2018) ("2018 ICI Fact Book"), at 256, *available at* [https://www.ici.org/pdf/2018\\_factbook.pdf](https://www.ici.org/pdf/2018_factbook.pdf).

<sup>3</sup> As of the end of 2017, there were over 600 target date funds, representing approximately \$1.1 trillion in assets. *Ibid.* at 73, 263.

shareholders' expectations and appropriate in light of current market conditions and other factors. Furthermore, funds of funds may provide shareholders with access to underlying funds or strategies that otherwise may not be available to them due to investment minimums or other eligibility requirements.

Open-architecture funds of funds such as the John Hancock target risk and target date funds and John Hancock Alternative Asset Allocation Fund<sup>4</sup> additionally provide shareholders with a convenient way to diversify their investment across a range of managers, while benefitting from the due diligence of the fund of funds' portfolio management team in selecting and allocating among underlying funds. Because funds of unaffiliated funds and open-architecture funds of funds are not limited to investing in affiliated funds, they are able to offer shareholders exposure to a broader range of underlying funds, strategies, markets, and asset classes than funds of affiliated funds. For example, an open-architecture fund of funds may be able to construct a portfolio consisting of a better-diversified mix of investment strategies that would not be available to a fund of affiliated funds. Investments in unaffiliated underlying funds may provide access to managers with differing investment approaches and areas of expertise or with the ability to offer those investment strategies at a lower cost (due to economies of scale) than comparable affiliated underlying funds. For example, the John Hancock funds of funds collectively invest in 112 different affiliated and unaffiliated underlying funds managed by 32 different advisors and subadvisors that provide particular expertise with respect to specific asset classes.

One suite of funds of funds that we manage – the Managed Volatility Portfolios<sup>5</sup> –illustrates the benefits of funds of funds arrangements. The investment objectives of the Managed Volatility Portfolios are twofold: (1) to seek growth of capital and, for certain Managed Volatility Portfolios, current income; and (2) to seek to both manage the volatility of return (as measured by annualized standard deviation of returns) within the volatility ranges noted in their prospectus and limit the magnitude of portfolio losses. To pursue their investment objectives, the Managed Volatility Portfolios allocate their assets among equity and fixed income underlying mutual funds and exchange traded funds (“ETFs”), as well as cash and cash equivalents. The Managed Volatility Portfolios also use certain derivative instruments, including equity index and fixed income futures, primarily for risk management purposes. Using a combination of these investments, the Managed Volatility Portfolios generally seek to reduce exposure to equity assets during periods of high anticipated and actual volatility in these asset classes and increase the exposure during less volatile periods.

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<sup>4</sup> The John Hancock target-risk and target date funds include four suites of retail funds comprising 38 separate portfolios: the Multi-Index 2010-2060 Lifetime Portfolios, the Multi-Index 2015-2060 Preservation Portfolios, Multi-Index Income Preservation Portfolio, the Multimanager Lifestyle Portfolios and the Multimanager Lifetime 2010-2060 Portfolios and three suites of funds offered on variable annuity and variable life insurance platforms: the Lifecycle 2010-2050 Trusts, the Lifestyle Portfolios, and the Managed Volatility Portfolios. John Hancock Alternative Asset Allocation Fund invests in underlying funds managed by a diverse set of specialized institutional asset managers to seek to provide instant diversification across alternative asset classes.

<sup>5</sup> The Managed Volatility Portfolios comprise five portfolios: Managed Volatility Aggressive Portfolio, Managed Volatility Balanced Portfolio, Managed Volatility Conservative Portfolio, Managed Volatility Growth Portfolio and Managed Volatility Moderate Portfolio. These portfolios are currently available for investment by insurance companies and their separate accounts as the underlying investment option for variable annuity and variable life insurance contracts and by qualified plans.

The managed volatility strategies of the Managed Volatility Portfolios were implemented following the global financial crisis of 2008-2009, during which market volatility and fluctuations and the associated depressed returns exceeded the risk tolerances of many investors. Accordingly, the Managed Volatility Portfolios were designed to seek to diversify risk, manage volatility of returns and limit the magnitude of portfolio losses. The successful implementation of a managed volatility strategy could translate into higher contract or policy values for owners over the long term (7 to 10 years). This, in turn, could result in greater available balances for contract owner withdrawals as well as improved benefits under the various contracts and policies, such as surrender benefits, death benefits or withdrawal benefits.

As discussed more fully below, we believe that the Proposal will have a significant, and unnecessary, negative impact on existing and future fund of funds arrangements, including John Hancock open-architecture funds of funds and the Managed Volatility Portfolios. We believe that it is important that the Proposal preserve the many benefits that funds of funds provide to shareholders and not discourage the use or development of these arrangements or frustrate the purpose of funds of funds investment options. However, absent significant revisions, we believe that the Proposal would adversely impact the ability of many funds of funds to effectively pursue their investment objectives and implement their investment strategies and would reduce the viability and availability of fund of funds structures, thereby harming shareholders.

### **III. Limited Redemptions Under the Proposed Rule**

#### **A. Concerns regarding the Limited Redemption Provision and Related Provisions**

##### **i. Impediments on the ability to reposition funds of funds or dispose of underlying fund shares.**

We believe that shareholders would be negatively impacted by the Limited Redemption Provision because it would lead to reduced investment flexibility, adversely impacting the ability of many funds of funds to effectively pursue their investment objectives and implement their investment strategies. While the Release cites figures that suggest that the Limited Redemption Provision would impact only a small number of funds of funds,<sup>6</sup> we do not believe this is consistent across the industry. Indeed, during the three-year period from January 1, 2016 to December 31, 2018, there were over 350 discrete instances in which John Hancock-sponsored funds of funds redeemed more than 3% of an underlying fund's outstanding shares. These redemptions were made because John Hancock Investments and the funds' subadvisors determined that they would be in the best interests of shareholders, including in situations where we believed that an underlying fund investment is likely to decline in value or that a reallocation of the fund's investment in an underlying fund would improve the fund's risk/return profile. In fact, many John Hancock underlying funds in which the John Hancock funds of funds invest

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<sup>6</sup> "From January 2017 to June 2018, 0.16% of the monthly redemptions of unlisted acquired funds exceeded the proposed 3% redemption limit. During that same period, 0.76% of the monthly redemptions of listed acquired funds exceeded the proposed 3% redemption limit." Fund of Funds Arrangements, SEC Release No. IC-33329, 84 Fed. Reg. 1,286 (Feb. 1, 2019) at 1,325, available at <https://www.govinfo.gov/content/pkg/FR-2019-02-01/pdf/2018-27924.pdf> ("Release").

were created to allow the funds of funds precisely this kind of investment flexibility. Further, certain of these underlying funds are held solely by affiliated funds of funds and have no other shareholders. The Limited Redemption Provision would prohibit a fund of funds from fully redeeming certain underlying fund positions despite such determinations by its managers that the redemptions are in the best interests of shareholders. Instead, a fund of funds would be required to redeem these positions gradually over time, effectively freezing the fund into positions that its manager has determined are no longer in the best interests of shareholders.

The inability of a fund of funds to fully redeem underlying fund positions could compromise the manager's ability to protect shareholders' investments by adjusting a fund of funds' investment strategy and holdings in response to changing or stressed market conditions. The loss of this investment flexibility could also affect a manager's ability to adjust underlying fund allocations in the ordinary course or to liquidate some or all of an underlying fund position when necessary or appropriate to meet shareholder redemptions.

In light of these potential issues, we believe that managers would have an incentive to preserve flexibility for the funds of funds they manage by selecting underlying fund positions that fall below the 3% threshold (for example, by investing in larger underlying funds), or by avoiding reliance on the Proposed Rule entirely (for example, by investing only in affiliated underlying funds in reliance on Section 12(d)(1)(G)), even when to do so would not otherwise be in the best interests of shareholders. These compromises may result in fund of funds portfolios that have less favorable risk/return characteristics than they would have if not subject to the Limited Redemption Provision. This new incentive would represent a substantial change in how funds of funds are managed and their resulting investment portfolios.

For similar reasons, we are concerned about the challenges that the Limited Redemption Provision would pose if a fund of funds needed to: (1) significantly reallocate its investments in underlying funds (for example, during a repositioning), (2) be liquidated, or (3) be reorganized into another fund. In each such case, the fund of funds' allocation to underlying funds may need to be adjusted significantly in a short amount of time, which may not be possible if the fund of funds held an underlying fund's shares in excess of the 3% threshold. As the Commission acknowledges, as a result of the Limited Redemption Provision, a fund of funds may need at least 10 months to fully unwind its investment in an underlying fund if the fund of funds holds up to the control limit of 25% of the underlying fund's total outstanding shares.<sup>7</sup>

Two recent examples involving John Hancock funds of funds demonstrate that this potential challenge is not merely theoretical. In 2013, the John Hancock Alternative Asset Allocation Fund (the "AAA Fund") invested approximately \$40 million in an unaffiliated underlying fund. Because the underlying fund had approximately \$650 million in assets at the time of purchase, the AAA Fund's holding represented about 4% of the unaffiliated underlying fund's total outstanding securities. The underlying fund subsequently had outflows of over \$500 million from other shareholders, causing the AAA Fund's position to balloon as a percentage of the underlying fund. In light of these circumstances, the AAA Fund's managers determined that it

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<sup>7</sup> *Ibid* at 1,320 and n. 260. This period may be in excess of 10 months if, for example, the fund of funds held more than 25% of the underlying fund's total outstanding shares because of the redemption activity of other direct shareholders.

would be in the shareholders' best interests to redeem the position, which was executed in a single day. Because such a redemption would not have been possible under the Limited Redemption Provision, they would likely have determined that the risk of holding an illiquid position in a shrinking fund outweighed the benefits of investing in the fund in the first place. Because the AAA Fund specifically seeks to invest in specialized managers of unique alternative asset classes, it is difficult to see how to manage the AAA Fund in the best interest of shareholders and consistent with its investment mandate if it is forced to operate within these constraints.

The challenges presented by the proposed Limited Redemption Provision would also not be limited to investments in unaffiliated underlying funds. In 2018, John Hancock Technical Opportunities Fund, an underlying fund for a number of John Hancock funds of funds, announced the retirement of its lead portfolio manager. At the time, the John Hancock funds of funds held in the aggregate 89% of the outstanding shares of the underlying fund, amounting to approximately \$420 million. Following this announcement, the funds of funds' managers determined to redeem their positions. Under the proposed rule, this redemption would have taken 73 months, as the amount the funds of funds could redeem would have been reduced each month as the underlying fund's assets decreased.

Additionally, if the sole shareholders of an underlying fund are funds of funds, as we have noted is the case for a number of John Hancock underlying funds, they may never be able to fully redeem their position in the underlying fund. Applying the Limited Redemption Provision to these funds, that are specifically designed to provide the flexibility that the Limited Redemption Provision eliminates and that do not have any other direct shareholders that could potentially be impacted by such decisions, seems particularly counterintuitive.

The above example of John Hancock Technical Opportunities Fund illustrates a portfolio managers' determination that a repositioning of a fund of funds' portfolio was in the best interests of the fund's shareholders following the departure of a key portfolio manager of the underlying fund. Similar to the need to reposition a fund of funds due to a portfolio manager change, a decision to reposition could arise following a change to an underlying fund's investment manager, sub-adviser, fee structure, or investment approach. Additionally, if the board of directors of a fund of funds determined that it should be liquidated or reorganized into another fund, but the fund of funds held positions in underlying funds subject to the Limited Redemption Provision, the restrictions on redeeming those positions could disrupt the orderly liquidation or reorganization of the fund of funds' portfolio, adding significant delay and complexity. We believe that the Proposed Rule should not inhibit adjustments to underlying fund allocations for these types of portfolio transitions, as they reflect the judgment of the fund of funds' board of directors or investment manager about what would be in the best interests of shareholders and do not raise any concerns of undue influence.

Target date funds, which are critical to retirement investors, would be particularly affected by the Limited Redemption Provision. Like many others, John Hancock target date funds use a "glide path" to determine how a fund's investments in underlying funds (and its underlying exposures to different asset classes) change over time as the fund approaches the end of its glide path (typically either near the investor's anticipated retirement date or at a later date during

retirement).<sup>8</sup> Since a target date fund generally invests in accordance with the glide path disclosed in its prospectus, it needs the ability to adjust its holdings of underlying funds at specific points in time. Shareholders of target date funds expect their holdings to follow these glide paths. However, if a target date fund relying on the Proposed Rule held an underlying fund position subject to the Limited Redemption Provision, its ability to adjust that position could be significantly delayed, which may impair its ability to comply with its stated glide path and cause the fund to have exposure to underlying asset classes, and, therefore, a risk/return profile, that differs from what shareholders would ordinarily expect. Depending on market conditions at the time, the resulting delays in the adjustment of a target date fund's underlying fund allocations may detract from performance (for example, if the target date fund is delayed in decreasing its underlying exposure to equities and increasing its underlying exposure to fixed income at a time when fixed income generally outperforms equities). These issues may lead a target date fund's portfolio manager to avoid underlying fund investments subject to the Limited Redemption Provision (*e.g.*, investments in a smaller underlying fund<sup>9</sup> where the target date fund's investment is more likely to exceed 3% of the underlying fund's outstanding shares) even when the manager otherwise believes those investments would be in the best interests of shareholders.

In addition, the Managed Volatility Portfolios would be particularly affected by the Limited Redemption Provision, as the Limited Redemption Provision could prevent a Managed Volatility Portfolio from timely reallocating its investments to fixed income underlying mutual funds and ETFs and cash and cash equivalents during periods of high volatility in the equity markets, thereby interfering with the Managed Volatility Portfolio's strategy and design as well as the reasonable expectations of contract and policy owners that have determined to invest in a Managed Volatility Portfolio for this very purpose. The Limited Redemption Provision could also cause a Managed Volatility Portfolio to close out its outstanding futures positions during inopportune times (for example, when the Managed Volatility Portfolio is seeking to satisfy redemption requests but is unable to do so using underlying fund positions because of the Limited Redemption Provision), potentially depriving the Managed Volatility Portfolio of the continued market exposure and interfering with its managed volatility strategy.

## **ii. Liquidity constraints for funds of funds and their shareholders.**

We believe that the Limited Redemption Provision would disadvantage individual investors who indirectly invest in an underlying fund through an investment in funds of funds vis-a-vis institutional investors who invest directly in the underlying funds. Because these direct investors would not be subject to the Limited Redemption Provision, they could redeem all or a portion of their investment in an underlying fund at any time regardless of the percentage of the underlying fund they held. An investor whose exposure to the same underlying fund came through an investment in a fund of funds relying on the Proposed Rule would, however, be limited by the Limited Redemption Provision. The result of this disparate treatment is that direct investors

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<sup>8</sup> 99% of target date fund assets are invested in funds of funds. 2018 ICI Fact Book at 74.

<sup>9</sup> We note that this outcome would be inconsistent with concerns that there may be "barriers making it harder for small and mid-sized fund sponsors to compete" in the current mutual fund marketplace and announced a planned outreach initiative targeting such fund sponsors. *See* Keynote Address: ICI Mutual Funds and Investment Management Conference, Dalia Blass, Director, Division of Investment Management (March 18, 2019), *available at* <https://www.sec.gov/news/speech/speech-blass-031819>.



would effectively have priority over funds of funds investors in accessing liquidity from the underlying fund, which could result in significant harm to individual shareholders (for example, during stressed market conditions in which the value of the underlying fund may be rapidly declining). In many cases, this would mean that retirement investors that hold funds of funds as part of a 401(k) would be disadvantaged relative to large, institutional investors that hold an underlying fund directly. Further, in a situation in which an underlying fund faces significant redemptions, this harm may be compounded as the underlying fund first sells its most liquid assets to finance the redemptions, thereby potentially diluting remaining investors' interests or changing the risk profile for remaining investors' interests.<sup>10</sup> Redemptions of the underlying fund by other investors could also cause a fund of funds to own an increasing percentage of the underlying fund's outstanding shares which could make it subject to the Limited Redemption Provision when it would not otherwise have been subject. We believe that such results are contrary to the Commission's intention to "lower the compliance costs and burdens" associated with funds of funds investments.<sup>11</sup>

The liquidity issues created by the Limited Redemption Provision may result in the need for funds of funds relying on the Proposed Rule to increase their reliance on lines of credit to meet shareholder redemptions. While lines of credit may be necessary to meet redemption requests under certain circumstances, particularly in times of stressed market conditions, we note that these come at a cost to shareholders. A fund is often required to pay a commitment fee to compensate the lending institution for a committed line of credit and would typically be required to pay interest and other expenses related to the loan.

### **iii. Unintended consequences under the SEC's Liquidity Rule.**

We believe the Limited Redemption Provision would result in unintended consequences under the Liquidity Rule, including by imposing significant operational challenges in implementing certain elements of the liquidity risk management program of an open-end fund of funds relying on the Proposed Rule.

Under the Liquidity Rule, a non-money market mutual fund is generally required to classify each of its portfolio investments into one of four liquidity "buckets" taking into account relevant market, trading and investment specific considerations, as well as the investment's so-called market depth. The market depth assessment involves determining whether trading varying portions of a position in a particular portfolio investment, in sizes that the fund would reasonably anticipate trading (each, a "**RATS**"), is reasonably expected to significantly affect the liquidity

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<sup>10</sup> The SEC's liquidity risk management rule – Rule 22e-4 under the 1940 Act (the "**Liquidity Rule**") – was designed, in part, to address these risks. See *Investment Company Liquidity Risk Management Programs*, SEC Release No. IC-32315, 81 Fed. Reg. 82142 (Nov. 18, 2016) at Section II.E ("**Liquidity Rule Adopting Release**") ("We anticipate that the new program requirement will result in investor protection benefits, as improved liquidity risk management could decrease the chance that a fund could meet its redemption obligations only with significant dilution of remaining investors' interests or changes to the fund's risk profile.") and n.164 ("When determining whether a fund's liquidity risk will cause significant dilution for purposes of this definition, a fund should consider the impact of liquidity risk on the total net assets of the fund and the adverse consequences such dilution will have on all the fund's remaining shareholders"), available at <https://www.govinfo.gov/content/pkg/FR-2016-11-18/pdf/2016-25348.pdf>.

<sup>11</sup> See Release, *supra* note 6, at 1,299.

of the investment. If so, this determination must be taken into account when classifying the liquidity of that investment. The classification determined on the basis of a position's RATS ordinarily applies to the entirety of the position.<sup>12</sup> Recent SEC Staff guidance was intended to facilitate compliance with the Liquidity Rule,<sup>13</sup> but the Limited Redemption Provision could introduce significant operational challenges in light of the Liquidity Rule's limitation on investments in "illiquid investments."

The Liquidity Rule prohibits a fund from acquiring any "illiquid investment" if, immediately after the acquisition, the fund would have invested more than 15% of its net assets in illiquid investments that are assets (the "**15% Limit**"). As defined in Rule 22e-4(a)(8), an "illiquid investment" is any investment that a 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, as determined pursuant to the Liquidity Rule's classification provisions (including the required market depth analysis). Typically, given the statutory prohibition on mutual funds suspending the right of redemption for more than seven days,<sup>14</sup> mutual fund shares would not be expected to be "illiquid investments."<sup>15</sup> The Limited Redemption Provision, however, could complicate this assumption and introduce significant operational challenges.

To the extent an open-end fund of funds holds more than 3% of an underlying fund's total outstanding shares, the fund of fund would need to assess whether those shares should be classified as illiquid in light of the Limited Redemption Provision and the 15% Limit. Considering the Liquidity Rule's market depth requirements, this would mean determining whether the RATS assigned to the position in the underlying fund exceeded 3% of its total outstanding shares (in which case, the entire position is immediately illiquid and counts toward the 15% Limit<sup>16</sup>). Even if the RATS does not initially exceed 3% of the underlying fund's total

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<sup>12</sup> See Liquidity Rule Adopting Release, *supra* note 10, at 82,182 ("If the fund determined, after conducting the required market depth analysis, that a downward adjustment in the liquidity classification of a particular investment is appropriate, the new liquidity classification that the fund assigns to this investment *would apply to the entirety of the fund's position in that investment* (not, as proposed, to portions of that position). This approach is meant to lessen burdens on funds, as well as respond to commenters' concerns, by focusing a fund's market depth considerations on circumstances in which a fund's practices in trading varying portions of its portfolio positions could have a disproportionate effect on its portfolio investments' liquidity.") (emphasis added).

<sup>13</sup> See Investment Company Liquidity Risk Management Programs Frequently Asked Questions ("**Liquidity Rule FAQs**"), available at <https://www.sec.gov/investment/investment-company-liquidity-risk-management-programs-faq>.

<sup>14</sup> See 1940 Act Section 22(e).

<sup>15</sup> See also Liquidity Rule FAQs, *supra* note 13, at FAQ No. 23 ("The staff believes that a fund that invests in other pooled investment vehicles ('pools') may focus on the liquidity of the pool's shares or interests when classifying those investments. . . . For pools that offer redeemable securities or withdrawal rights (*e.g.*, mutual funds or private funds), the staff believes that a fund generally would focus on the pool's ordinary redemption rights or practices, and 'look through' to the pool's underlying investments only under circumstances when the fund has a reason to believe that the pool may not be able to honor those rights or meet redemptions in accordance with its customary practice.").

<sup>16</sup> An open-end fund of funds may be able to classify different portions of the position in different liquidity "buckets" under instructions to Item C.7 of Form N-PORT. However, although this may impact the percentage of a fund's net assets that are classified as illiquid, it does not reduce the compliance burden or complexity of these practices.

outstanding shares, it would mean monitoring, on a rolling 30-day basis, whether the fund of funds' RATS exceeds this 3% threshold on a later date. Complicating things further, each of the above scenarios assumes knowledge of what amount constitutes 3% of the underlying fund's total outstanding shares – *i.e.*, to facilitate the monitoring described above, the fund of funds may need a way to monitor, on frequent basis,<sup>17</sup> the value of the underlying fund's total outstanding shares.

The Limited Redemption Provision would result in additional adverse consequences for fund of funds and their shareholders besides the operational challenges described above. For example, an underlying fund position being classified as illiquid as a result of the Limited Redemption Provision could force an open-end fund of funds to adjust its portfolio composition to avoid violating the 15% Limit. An open-end fund of funds' ability to take corrective action where the 15% Limit has been exceeded could also be frustrated as a result of the Limited Redemption Provision. Indeed, under the Limited Redemption Provision, an open-end fund of funds may be unable to unwind its investments in underlying mutual fund shares as quickly as it would be able to otherwise. Thus, in some cases, the Limited Redemption Provision could prolong the duration of a 15% Limit breach and could limit the options available to fund management to appropriately remediate such a breach in a manner that the adviser deems consistent with its fiduciary duties to the open-end fund of funds.

Thus, the Limited Redemption Provision would present significant operational challenges in implementing certain elements of the liquidity risk management program of an open-end fund of funds relying on the Proposed Rule. Such an outcome is inconsistent with the Commission's stated goals in adopting the Liquidity Rule<sup>18</sup> as well as the Commission's stated goals in adopting the Proposed Rule.<sup>19</sup>

#### **iv. Disparate treatment of similar investments and resulting incentives for fund of funds managers.**

While a stated goal of the Proposed Rule is to create a consistent regulatory framework for all registered funds investing in underlying funds,<sup>20</sup> the Proposed Rule actually requires different treatment for similar fund of funds investments. This provides strong incentives to managers of funds of funds to favor investments in affiliated underlying funds over those in unaffiliated underlying funds, to favor investments in underlying funds that are traded on an exchange (such

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<sup>17</sup> Although the Liquidity Rule formally requires liquidity classifications only on a monthly basis, monitoring for compliance with the 15% Limit is an ongoing obligation. *See, e.g.*, Liquidity Rule FAQs, *supra* note 13, at FAQ No. 31 ("The staff believes that a fund should implement reasonably designed policies and procedures to appropriately limit illiquid investments, so that the fund will not acquire any illiquid investment that would cause it to exceed this 15% limitation.").

<sup>18</sup> One of the primary goals of the Liquidity Rule is to "provid[e] funds with reasonable flexibility to adopt policies and procedures that would be most appropriate to assess and manage their liquidity risk." Liquidity Rule Adopting Release, *supra* note 10, at 82, 158.

<sup>19</sup> The Commission intends that the Proposed Rule would "lower the compliance costs and burdens" associated with funds of funds investments. *See* Release, *supra* note 6, at 1,299.

<sup>20</sup> *See ibid.* at 1,288.

as ETFs<sup>21</sup> and listed closed-end funds) over those in non-exchange-traded funds, to favor investments in larger underlying funds over those in smaller underlying funds, and to avoid making direct investments in securities. It is likely that as a result of these incentives, the universe of underlying funds and other investments available to funds of funds would become more limited, which would harm shareholders by restricting their investment choices and eliminating many of the diversification benefits that fund of funds arrangements offer.

The Proposed Rule, if adopted, would result in disparate treatment of funds of affiliated funds on one hand and funds of unaffiliated funds or open-architecture funds of funds on the other. While investments in both affiliated and unaffiliated underlying funds would be available under the Proposed Rule, in light of the proposed rescission of Rule 12d1-2, only investments solely in affiliated underlying funds would be available under the statutory exemption in Section 12(d)(1)(G). Because Section 12(d)(1)(G), unlike the Proposed Rule, does not contain any limits on redemptions of underlying funds, we believe that the Proposed Rule would create incentives for managers to prefer funds of affiliated funds (which are eligible for relief under Section 12(d)(1)(G)) over funds of unaffiliated funds (which are not).

If the Proposed Rule is adopted as proposed, investments in affiliated underlying funds would be treated differently depending on whether they are made in reliance on the Proposed Rule or on Section 12(d)(1)(G). While a fund of affiliated funds relying on the Proposed Rule would be subject to the Limited Redemption Provision, an otherwise identical fund of affiliated funds eligible to rely on Section 12(d)(1)(G)<sup>22</sup> would be able to acquire an underlying fund's shares without being subject to the same redemption limits. Conversely, given the proposed rescission of Rule 12d1-2, a fund of affiliated funds relying on the Proposed Rule would be permitted to make investments in securities directly, while an otherwise identical fund of affiliated funds relying on Section 12(d)(1)(G) would not (beyond those securities specifically permitted by Section 12(d)(1)(G)). As a result, two substantially identical funds of affiliated funds relying on Section 12(d)(1)(G) (and not subject to the Limited Redemption Provision) would be treated differently if one were to make a single direct investment in securities (and therefore become unable to rely on Section 12(d)(1)(G)). Such a fund would be compelled to rely on the Proposed Rule and would become subject to the Limited Redemption Provision when the other fund without any direct investments in securities (and therefore still able to rely on Section 12(d)(1)(G)) would not.

The Commission asserts that the Limited Redemption Provision is intended to provide a check against undue influence.<sup>23</sup> However, we do not believe that the two otherwise identical funds discussed in the example above pose any meaningfully different risk of undue influence given a single direct investment by one such fund in securities. Moreover, we do not believe that the

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<sup>21</sup> The Release notes that an acquiring fund would need to adhere to the Limited Redemption Provision if purchasing an ETF or ETMF from an authorized participant on the primary market. *See* Release at 1,299. However, our understanding is consistent with the Commission's understanding that this is much less common.

<sup>22</sup> Funds may rely on Section 12(d)(1)(G) if their investments in underlying funds are limited to those that are registered open-end funds or unit investment trusts in the same group of investment companies and unaffiliated money market funds.

<sup>23</sup> *See* Release at 1,298.

disparate treatment for funds of affiliated funds under the Proposed Rule is warranted given existing controls on their exercise of undue influence over their underlying funds. In the Release, the Commission noted that, if a fund of funds and underlying fund share an adviser, the adviser would owe a fiduciary duty to both funds.<sup>24</sup> We agree with the Commission's conclusion that, in such cases, "we do not believe that the [underlying] fund adviser generally would seek to benefit the [fund of funds] at the expense of the [underlying] fund (nor do we believe that the [fund of funds] would seek to influence the [underlying] fund through its ownership interest in the [underlying] fund)." And we would assert that these same principles would also apply to redemption decisions.<sup>25</sup> The Commission further stated that the Limited Redemption Provision would "mitigate against the risks of undue influence" among funds with advisers that are control affiliates.<sup>26</sup> We believe that the Proposed Rule's inclusion of the Limited Redemption Provision unfairly disadvantages funds of funds relying on that Rule by imposing an unnecessary burden that would not apply to identically situated funds of funds relying on Section 12(d)(1)(G).

We believe that the result of the disparate treatment of similarly situated funds of affiliated funds under the Proposed Rule would be that managers of those funds would have a strong incentive to avoid making direct investments in securities, which would limit their flexibility in constructing portfolios or would require them to construct more complex and costly structures to gain exposure to those investments indirectly. Moreover, it is unclear whether, following the adoption of the Proposal, funds of affiliated funds relying on Section 12(d)(1)(G) would be able to continue to invest in non-securities, including derivatives, in reliance on the *Northern Lights Fund Trust* no-action letter.<sup>27</sup> If no longer able to rely on this no-action letter, certain funds of funds, such as Managed Volatility Portfolios frequently offered on variable insurance platforms that seek to provide downside protection through the use of futures, would not be able to rely on Section 12(d)(1)(G) even if they otherwise only held affiliated underlying funds. In light of the Limited Redemption Provision under the Proposed Rule, it is unclear whether fund complexes would continue to offer these products.

As a general matter, we believe that there are compelling reasons for funds of affiliated funds, funds of unaffiliated funds, and open-architecture funds of funds to be treated similarly, including to preserve investors' ability to access the unique benefits offered by funds of unaffiliated funds and that unaffiliated funds should be available for investment by funds of funds without unnecessary structural impediments. The disparate treatment described above creates an uneven playing field and is harmful to shareholders, and the concerns expressed by the Commission could be addressed through more even-handed means than those contemplated by the Proposed Rule. We note that the Commission has thus far granted numerous Section 12(d)(1) Orders enabling funds of funds to access unaffiliated funds in excess of Section 12(d)(1)(A) limits subject to certain conditions. The conditions currently imposed by those Section 12(d)(1) Orders to eliminate concerns of undue influence (requiring, for example, the use of participation agreements and board findings and procedures) have addressed the

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<sup>24</sup> *Ibid.* at 1,297.

<sup>25</sup> *Ibid.*

<sup>26</sup> *Ibid.*

<sup>27</sup> *Northern Lights Fund Trust*, SEC Staff No-Action Letter (June 29, 2015), available at <https://www.sec.gov/divisions/investment/noaction/2015/northern-lights-fund-trust-063015.htm>.

Commission's concerns most relevant to funds of unaffiliated funds and, if codified – as they are or in a modified form – could provide a standardized framework for funds of funds arrangements going forward. We would further note that best practices around the implementation of Section 12(d)(1) Orders and Boards' oversight with respect to the conditions thereunder, which are generally quite similar among different Orders, has already been established across the industry and could provide a strong foundation for a regulatory framework.

Additionally, a manager of a fund of funds subject to the Limited Redemption Provision may have an incentive to favor investments in larger underlying funds over those in smaller underlying funds because it would make it easier for the fund of funds to stay below 3% of the underlying fund's outstanding securities and thus not trigger the 3% redemption limit. This would ultimately limit the manager's investment flexibility, as smaller underlying funds may offer investment strategies and exposures that would otherwise be better suited for the fund of funds' portfolio.

Taken together, we believe the incentives that the Proposed Rule would create for funds of funds to systematically favor certain investments over others would be harmful to the shareholders of those funds, as portfolio management decisions about an investment opportunity would be made in part with a view to the potential burdens imposed by the Proposed Rule in connection with that investment rather than purely on the contribution of the investment to the construction of a cost-effective portfolio with appropriate risk/return characteristics designed in the best interests of shareholders.

## **B. Consequences of the Limited Redemption Provision**

For the reasons discussed above, we believe that the Proposed Rule, and particularly the Limited Redemption Provision, would likely result in a larger impact on funds of funds than anticipated by the Commission. The Commission notes in the Release that, as of June 2018, 809 of 4,342 funds of funds held more than 3% of the outstanding shares of at least one underlying fund.<sup>28</sup> Therefore, at that time, nearly 20% of funds of funds would have been impacted by the Limited Redemption Provision. In addition, 28 out of 55 John Hancock-sponsored funds of funds, representing approximately \$68.6 billion in assets, held more than 3% of the outstanding shares of at least one underlying fund as of December 31, 2018. Because a majority of our funds of funds would have been impacted by the Limited Redemption Provision, we suspect that the industry-wide figure would be significantly higher if tracked over a longer period of time.

The Release also cites figures that suggest that the Limited Redemption Provision would impact only a small portion of funds since a low percentage of funds of funds redeemed more than 3% of an underlying fund's outstanding shares within one month during the period examined by the Commission.<sup>29</sup> The low rate of large-scale redemptions within the industry cited by the Release may imply that funds of funds today are generally not exercising undue influence in this way, notwithstanding the lack of any redemption restrictions. We are unaware of any actual instances in which a fund of funds has made an attempt to exercise undue influence through the threat of

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<sup>28</sup> See Release at 1,323.

<sup>29</sup> *Ibid.* at 1,325.

redemptions. While we understand the Commission's concern that large redemptions by funds of funds, even in the absence of attempts at undue influence, may adversely impact shareholders of underlying funds, we note that large-scale redemptions are frequently negotiated to minimize any such impact. For example, underlying funds typically retain the ability to redeem in-kind for redemptions exceeding a certain percentage of the fund's assets. The ability to redeem in-kind protects shareholders from incurring transaction costs and capital gains tax, and can be used by underlying funds as a point of leverage in negotiating a favorable redemption schedule. Further, funds of funds' investment advisors currently employ robust compliance and oversight controls and processes to ensure that improper activity such as the exercise of undue influence on an underlying fund is avoided. For example, John Hancock utilizes a Trade Oversight Committee that meets regularly to thoroughly review proposed redemptions and many other types of fund events to ensure that they are appropriate and comply with our compliance policies and procedures.

We note that the Commission acknowledged that the Limited Redemption Provision may have a more substantial impact during times of market stress or heightened volatility.<sup>30</sup> We agree and, for reasons noted above, believe the provision would carry a particular risk of potential harm to fund of funds shareholders at those times. To minimize that risk of harm, we urge the Commission to eliminate the Limited Redemption Provision or, to the extent that the Commission determines to retain that provision, to consider the alternative proposals suggested below.

### **C. Proposals to Address Limited Redemption Provision Concerns**

We applaud the Commission for identifying an area in the regulatory framework that lends itself to simplification and standardization. We agree that the same rules and principles should apply to all industry participants, and that a straightforward and equitable regulatory approach ultimately benefits investors. We suggest below several proposals for the Commission to consider in relation to the Limited Redemption Provision, that we believe could better achieve the benefits to shareholders that the Commission seeks to protect, including the preservation of investor choice. We further believe our proposals could achieve the Commission's goals in a manner that is fairer to all industry participants and minimizes impact on currently offered products that provide desirable and appropriate services to investors. As we have discussed above, we believe that the Limited Redemption Provision, as currently proposed, would negatively impact the shareholders of funds of funds and therefore recommend that the provision be eliminated. We would instead propose to codify certain additional conditions in existing exemptive relief to address the undue influence concerns the Commission has raised. Alternatively, we have included other approaches that would mitigate some of the unintended negative consequences.

#### **i. Replace Limited Redemption Provision with codified conditions from existing exemptive relief.**

The Commission based the conditions in the Proposed Rule on the conditions imposed by the Section 12(d)(1) Orders, with certain modifications intended to streamline compliance and

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<sup>30</sup> See *ibid.* at 1,299.

strengthen investor protections.<sup>31</sup> The Commission proposed the Limited Redemption Provision to address concerns that funds of funds could exercise undue influence over underlying funds.<sup>32</sup> The Limited Redemption Provision was designed to replace the conditions in the Section 12(d)(1) Orders requiring that, with respect to funds of funds investments in unaffiliated funds,<sup>33</sup> (1) fund boards make certain findings and adopt procedures<sup>34</sup> and (2) funds of funds and underlying funds enter into participation agreements that state that the funds understand and agree to comply with the terms and conditions of the Order (the “**Existing Conditions**”).<sup>35</sup>

We believe that the Existing Conditions are largely standardized across the industry and have been functioning effectively for years to protect underlying unaffiliated funds against potential overreach and undue influence by funds of funds and do not believe these Existing Conditions are unduly burdensome. We believe that codifying the Existing Conditions, in a modified form or as they are, would address the concerns identified by the Commission in the Release and would be preferable to imposing the Limited Redemption Provision in light of the issues associated with the Limited Redemption Provision, as outlined above. For consistency with the Existing Conditions and in light of the diminished opportunities for undue influence by a fund of funds over its affiliated underlying funds due to fiduciary duty principles, we would propose that the conditions, as codified in the Proposed Rule, apply only to funds of unaffiliated funds and open-architecture funds of funds, not funds of affiliated funds which could continue to rely on Section 12(d)(1)(G).

In codifying the protections in the Existing Conditions in lieu of the Limited Redemption Provision, we would propose certain modifications for administrative ease. First, while it has been our experience that the cost associated with entering into participation agreements is relatively minimal as the standardization of terms and broad use in the industry has reduced negotiation efforts, to capture those minimal cost savings and create greater administrative convenience, we would propose that, rather than requiring the execution of a participation agreement, the Proposed Rule instead include a notification provision that would require each of the fund of funds and the underlying fund, prior to exceeding the investment limits in Section 12(d)(1)(i), to provide reciprocal written acknowledgement that the funds would rely on the Proposed Rule and would comply with the conditions therein. This requirement would mitigate

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<sup>31</sup> *Ibid.* at 1,293.

<sup>32</sup> *Ibid.* at 1,298.

<sup>33</sup> The Existing Conditions are based on conditions from Section 12(d)(1) Orders granted to funds of unaffiliated funds.

<sup>34</sup> The conditions in the Section 12(d)(1) Orders require that the boards of each of the fund of funds and the underlying fund make certain findings and adopt certain procedures to prevent overreaching and undue influence by the fund of funds and its affiliates once the investment in an unaffiliated underlying fund exceeds the Section 12(d)(1) limits. For example, the underlying fund’s board must adopt procedures reasonably designed to monitor purchases by the underlying fund in an underwriting in which an affiliate of the fund of funds is the principal underwriter. The fund of funds must take measures to prevent the underlying fund from influencing the terms of any services or transactions between the fund of funds and an underlying fund or causing an underlying fund to purchase a security in any affiliated underwriting. The fund of funds board must adopt procedures reasonably designed to assure that the fund of funds’ investment adviser does not take into account consideration received from the underlying fund or certain of its affiliates.

<sup>35</sup> See Release at 1,333.



the Commission's undue influence concerns without the need for the Limited Redemption Provision or a similar redemption limit, as it would allow underlying funds to block the acquisition of their shares by a fund of funds that they believed could exercise undue influence over them. Second, we would further propose that the Existing Conditions be modified such that the advisers to the fund of funds and underlying funds undertake the review and monitoring obligations currently residing with their boards, subject to the advisers' reporting to the respective boards regarding their fulfillment of these obligations. This would be consistent with the Commission's recent efforts to align fund directors' regulatory responsibilities with the oversight role that the Commission has assigned to fund boards with respect to compliance.<sup>36</sup> Under this approach, for example, the adviser to the underlying fund, as opposed to the underlying fund board, would monitor purchases by the underlying fund in an underwriting in which an affiliate of the fund of funds is the principal underwriter. The adviser would review these purchases no less frequently than quarterly to make a determination, which would be reported to the board, as to whether the purchases were influenced by the investment by the fund of funds in the underlying fund.

Even without the modifications proposed above, we believe that codification of the Existing Conditions would be preferable to imposing the Limited Redemption Provision because the Existing Conditions prevent overreaching and undue influence without the liquidity and investment flexibility constraints imposed by the Limited Redemption Provision.

## **ii. Proposal of cap on investments in unaffiliated underlying funds.**

We separately propose that, in lieu of the Limited Redemption Provision, the Commission impose a limit on a fund of funds' investment in an unaffiliated underlying fund to no more than 20% of the underlying fund's total outstanding shares. Fund of funds arrangements serve a variety of different functions and, thus, do not uniformly present concerns of undue influence. The Release notes, for example, that "fund of funds arrangements involving control affiliates do not raise the same concerns regarding undue influence as other types of fund of funds arrangements."<sup>37</sup> We likewise believe that a fund of funds holding 20% or less of an unaffiliated underlying fund's total outstanding shares does not pose the same risks associated with large-scale redemptions as a fund with a larger position in the unaffiliated underlying fund. We note that a 20% limit on a fund of funds' investment in an unaffiliated underlying fund would be consistent with the "passive investor" standard reflecting a lack of activist intent under Section 13(d) of the Securities Exchange Act of 1934, as amended.

We believe that a limit on a fund of funds' investments in unaffiliated underlying funds would appropriately address the Commission's concerns without unduly restricting the many types of fund of funds arrangements that do not implicate those concerns. Moreover, a limit on such investments would resolve many of the problems that the Limited Redemption Provision introduces. As discussed above, the Limited Redemption Provision imposes potentially onerous

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<sup>36</sup> See Dalia Blass, Director, Division of Investment Management, SEC, Keynote Address: ICI Securities Law Developments Conference (Dec. 7, 2017); *see also* Independent Directors Council, SEC No-Action Letter (Oct. 12, 2018).

<sup>37</sup> See Release, *supra* note 6, at 1,333.

liquidity constraints on funds of funds and subjects different fund types to disparate treatment. By contrast, a limit on investments in unaffiliated underlying funds would effectively guard against undue influence while avoiding these liquidity constraints and mitigating concerns about disparate treatment among fund types. Further, it would do so while also imposing a meaningfully lower investment maximum for investments in unaffiliated underlying funds than the control limit of 25% set forth in the Proposed Rule.

We further propose that an advisory group's holdings not be aggregated for purposes of determining whether a given fund of funds is compliant with this limit. Aggregation of advisory group holdings increases the likelihood that a fund of funds will inadvertently breach this limit, even where no individual fund raises undue influence concerns itself. Such circumstances may lead to funds of funds being managed with a view towards group-wide holdings instead of fund-specific shareholder objectives. We believe that determining compliance at the fund level instead would provide fund complexes with important latitude, allowing individual funds to each invest in other funds consistent with their respective investment objectives while still being subject to the 25% control limit at the advisory group level.

### **iii. Alternative proposals if the Limited Redemption Provision is retained.**

If the Commission determines that the Limited Redemption Provision should be retained, we would propose several modifications that could be made, individually or collectively, to alleviate some of the concerns discussed above. We reiterate, however, that even with certain or all of these proposed modifications in place, the impact on how funds of funds are managed would be significant, and the continued viability of certain current funds of funds structures such as John Hancock open-architecture funds and the Managed Volatility Portfolios would still be in question.

#### **1. Provide exceptions for investment decisions made in accordance with applicable compliance policies and procedures.**

We believe that, in the event that the Limited Redemption Provision cannot be eliminated, an exception to that provision should be provided if the portfolio manager of a redeeming fund of funds determines to redeem a position based on an appropriate investment rationale and not as an attempt to unduly influence an underlying fund. Such an investment decision could be appropriate, for example, in the event a fund of funds needs to adjust or redeem its underlying fund positions in connection with a repositioning (including in response to changes in the underlying funds' investment manager, sub-adviser, portfolio managers, fee structure, or investment approach), meeting shareholder redemption requests, liquidation, merger, or other situation necessitating a significant portfolio transition in a short period of time.<sup>38</sup> We would

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<sup>38</sup> We note that, in certain prior Section 12(d)(1) Orders, the Commission restricted the ability of a fund of funds from redeeming underlying fund shares beyond a specific threshold. Importantly, however, these conditions did not apply to redemptions "where necessary to meet [a fund of funds'] shareholder redemption requests." See T. Rowe Price Spectrum Fund, Inc., et al.; Notice of Application, Securities and Exchange Commission, Release No. IC-17198 (Oct. 31, 1989) (notice) and (Nov. 29, 1989) (order). This order was subsequently superseded and this condition was removed. One of the applicants many arguments in favor of removing this condition was that it was not necessary to protect investors and was instead an impediment to "prudent investment management."

propose that this be implemented through a regulatory carve out to the Limited Redemption Provision pursuant to which a fund of funds would adopt policies and procedures reasonably designed to ensure that transactions are executed for appropriate reasons. We believe that, without such an exception, the Limited Redemption Provision would present the significant challenges to the completion of these kinds of portfolio transitions as more fully described above.

**2. Eliminate the application of the Limited Redemption Provision to affiliated underlying funds.**

If the Limited Redemption Provision cannot be eliminated entirely, we believe that it should not be applied to affiliated underlying funds. If a fund of funds and an underlying fund share an adviser, the adviser would owe a fiduciary duty to both funds. As stated above, we believe that, in those circumstances, the adviser generally would not seek to benefit the fund of funds at the expense of the underlying fund or to influence the underlying fund through the fund of funds' ability to redeem its investment in that underlying fund.<sup>39</sup> As a result, we believe that the risk of a fund of funds seeking to exercise undue influence an affiliated underlying fund through the threat of a large redemption is sufficiently remote that the Limited Redemption Provision would not provide any meaningful protection to the underlying fund or its shareholders despite imposing significant burdens on the fund of funds, as discussed above.

**3. Make the limit on a fund of funds' redemptions of an unaffiliated underlying fund optional at the election of the underlying fund.**

In the case of unaffiliated underlying funds, we believe that if the Limited Redemption Provision cannot be eliminated, the redemption restrictions contemplated by the Proposed Rule should be changed from mandatory to optional at the election of the underlying fund. We believe that this election should be subject to a reasonableness restriction, so that an underlying fund could not unreasonably withhold permission to redeem from funds of funds. As explained in the Release, the Limited Redemption Provision is intended "to address concerns that an acquiring fund could threaten large redemptions as a means of exercising undue influence over an [underlying] fund."<sup>40</sup> Allowing, but not requiring, underlying funds to block large redemptions (when acting reasonably) would address the Commission's concerns regarding undue influence without relying on an arbitrary requirement restricting redemptions for all underlying funds that would have a negative impact on fund of funds shareholders. Instead, the determination about whether redemption restrictions were necessary to prevent undue influence would be made by the underlying fund itself, which would be best situated to make that determination.

In situations where an underlying fund determined that the risks of undue influence were not such that a redemption restriction was necessary, this would allow funds of funds to be able to continue to make larger investments in the underlying fund without compromising investment flexibility or having to deem some or all of that investment as illiquid for purposes of the Liquidity Rule. We believe that this type of framework would adequately mitigate the risk of

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<sup>39</sup> Release at 1,333.

<sup>40</sup> *Ibid.* at 1,298.

potential harm to underlying fund investors resulting from large redemptions by funds of funds. We believe this risk is relatively small, as we are not aware of funds of funds using the threat of redemptions as a means to influence an underlying fund in practice and believe that the size and timing of large-scale redemptions commonly are negotiated to minimize other potential negative impacts to underlying fund investors.

**4. Provide exceptions for 3% exceedances solely due to redemptions by other underlying fund shareholders.**

If a fund of funds purchases shares that represent less than 3% of an underlying fund's outstanding securities at the time of purchase, but the percentage of outstanding securities owned by the fund of funds rises above 3% as a result of a decrease in the outstanding securities of the underlying fund (and without further purchases by the fund of funds), we believe the fund of funds' investment should be excepted from the Limited Redemption Provision. The Release provides a similar exception to Rule 12d1-4(b)(1)(i).<sup>41</sup> In that case, if the fund of funds becomes a holder of over 25% of the outstanding securities of an underlying fund due to net redemptions, the fund of funds does not need to dispose of underlying fund shares, although it would be prohibited from acquiring additional shares of the underlying fund. We believe that this exception would be especially important under stressed market conditions when both underlying funds and funds of funds are more likely to experience net redemptions and funds of funds may need to liquidate portfolio investments (including investments in an underlying fund) to generate cash to finance shareholder redemptions. Under the Proposed Rule, a fund of funds experiencing liquidity issues could find those issues exacerbated if its positions in one or more underlying funds were to surpass the 3% limit and become subject to the Limited Redemption Provision, restricting the fund of funds' redemption of those investments.

**IV. Structural Issues Under the Proposal**

In addition to our concerns regarding the Limited Redemption Provision, we are also concerned about the unintended consequences the Proposal may have for fund of funds structures, including as a result of the proposed rescission of Rule 12d1-2 and the Section 12(d)(1) Orders. We discuss these concerns and our proposals to address these concerns below.

**A. Concerns Regarding the Proposed Rescission of Rule 12d1-2 and the Section 12(d)(1) Orders and Other Unintended Structural Consequences**

**i. Funds of affiliated funds need to reevaluate their investments in unaffiliated funds, direct securities, and derivatives and other non-securities.**

The Proposal contemplates the rescission of Rule 12d1-2, which is currently available to funds of affiliated funds relying on Section 12(d)(1)(G) to permit certain investments in unaffiliated underlying funds, securities (other than securities issued by an investment company), and money market funds. If the Proposal is adopted, funds of affiliated funds investing beyond the Section 12(d)(1)(A) limits would need to rely on either the Proposed Rule or Sections 12(d)(1)(E), (F) or

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<sup>41</sup> *Ibid.* at 1,295.

(G). If relying on Section 12(d)(1)(G), funds of affiliated funds would be permitted to invest in unaffiliated money market funds pursuant to Rule 12d1-1, as proposed to be amended, but would no longer be able to invest in other unaffiliated underlying funds or in direct securities other than U.S. government securities and commercial paper. Also, as we note above, the continued ability of funds to invest in non-securities if relying on Section 12(d)(1)(G) is unclear. Funds of affiliated funds relying on the Proposed Rule could continue to invest directly in unaffiliated underlying funds, securities, money market funds, and non-securities, but would become subject to the Limited Redemption Provision and other restrictions included in the Proposed Rule.

As a result of the proposed rescission of Rule 12d1-2, we believe that existing funds of affiliated funds intending to rely on Section 12(d)(1)(G) would need to reevaluate their investments in unaffiliated underlying funds, direct securities, derivatives, and other instruments. As previously discussed, the Managed Volatility Portfolios, which utilize futures or other instruments to seek to provide shareholders with downside protection, present one clear example of an existing fund of funds arrangement that would be endangered under the Proposed Rule. Funds of affiliated funds may need to implement extensive and costly portfolio changes in order to eliminate these types of positions. We agree with the Commission's suggestion that portfolio changes required for existing funds of funds to comply with the Proposed Rule could: "(i) impose transaction costs on acquiring funds; (ii) force acquiring funds to sell the shares of acquired funds at potentially depressed prices; (iii) disrupt the acquiring funds' investment strategy; (iv) impose liquidity demands on acquired funds as a result of the acquiring fund redemptions; and (v) have tax implications, which would depend on whether the acquiring fund would sell appreciated or depreciated shares of acquired funds," with negative impacts more pronounced for funds with unaffiliated underlying funds.<sup>42</sup> While the Commission recognized that these potential costs may occur, we believe that the costs are likely to be much greater than anticipated and have not been appropriately weighed against the potential benefits of the proposed rescission of Rule 12d1-2 and the Section 12(d)(1) Orders, which we believe are negligible. We therefore recommend that, to the extent the SEC rescinds Rule 12d1-2 in the final rulemaking, the Commission eliminate the Limited Redemption Provision, which would minimize some of the consequences associated with rescinding Rule 12d1-2 and preserve the continued viability of certain existing fund of funds arrangements.

**ii. The Proposed Rule would rescind existing exemptive orders providing Section 12(d)(1) relief.**

The Proposed Rule would rescind exemptive orders providing relief from Sections 12(d)(1)(A), (B), (C), and (G) of the 1940 Act except for those providing relief from Section 12(d)(1)(A) and (B) to permit certain interfund lending arrangements. We expect the rescission of these Section 12(d)(1) Orders to impact many funds of funds, which, in most cases, would need to be restructured to comply with the Proposed Rule or with Section 12(d)(1)(G). We therefore recommend that, to the extent the SEC rescinds the Section 12(d)(1) Orders in the final rulemaking, the Commission eliminate the Limited Redemption Provision, which would minimize some of the consequences associated with rescinding the Section 12(d)(1) Orders and preserve the continued viability of certain existing fund of funds arrangements.

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<sup>42</sup>*Ibid.* at 1,321.

**iii. The Proposed Rule may encourage alternative complex product structures.**

We believe that the constraints imposed by the Proposed Rule, as discussed above, would likely incentivize investment managers to find alternative product structures that provide more investment flexibility and avoid the burdens imposed by the Proposed Rule. If the Commission rescinds exemptive relief or adopts a rule that would not allow funds of funds to continue to operate in the same way, the investment managers of such funds of funds may be inclined to seek other structures that would allow their funds to be managed more similarly. We note that, contrary to the Commission's intention, some of these structures may be unregulated or may be more complex or have higher costs. For example, we believe that some investment managers may elect to rely more heavily upon unregistered products or may use multiple portfolio sleeves within a single registered fund, which could potentially introduce additional costs and administrative complexities.

**B. Proposals to Address Structural Concerns**

To the extent the Limited Redemption Provision is not removed from the final rulemaking, we would propose that the Commission retain Rule 12d1-2 in order to preserve the flexibility of funds relying on Section 12(d)(1)(G) to invest in unaffiliated funds and direct securities. We would also propose that the Commission amend Rule 12d1-2 to permit funds relying on Section 12(d)(1)(G) to invest in non-securities, including derivatives – effectively codifying the relief from the *Northern Lights Fund Trust* no-action letter. Further, we would suggest the Commission take a more tailored approach to rescinding any Section 12(d)(1) Orders to limit disruption to and restructuring of existing fund of funds arrangements that rely on such orders. We further suggest that if the Proposed Rule is implemented as proposed, a *de minimis* exception be included to the prohibition on funds of funds relying on Section 12(d)(1)(G) directly holding non-fund securities for small positions a fund of funds may hold. Such small positions in non-fund securities may be held for various reasons, such as for orphaned illiquid securities a fund might inherit upon the liquidation of an underlying fund. We note that the Proposed Rule would require a fund of funds' adviser to determine, before investing in any underlying fund in reliance on the Rule, that it is in the best interest of the fund to invest in the underlying fund. If the Commission determines that additional protections are necessary with respect to the preservation of Rule 12d1-2 or certain exemptive orders, we would suggest that the same best interest determination by the adviser be required with respect to investments in underlying funds, direct securities, and derivatives in connection with that Rule or in connection with certain underlying investments permitted by order.

**C. Separate Accounts Funding Variable Insurance Contracts**

The Proposal would require that a fund of funds obtain a certification from the insurance company issuing the separate account that the insurance company has determined that the fees borne by the separate account, acquiring fund, and acquired fund, in the aggregate, are consistent with the standard set forth in Section 26(f)(2)(A) of the 1940 Act. We believe this certification requirement is unnecessary given the current statutory framework in place with respect to variable contract and underlying fund fee structures (in the form of Section 26(f)(2)(A) and Sections 15(c) and 36(b) of the 1940 Act, respectively), as well as the Proposed Rule's

requirement relating to the best interest determination by the fund of funds' manager with respect to investments in acquired funds.<sup>43</sup> This statutory and regulatory framework provides extensive protections to investors in variable contracts that the fees and expenses imposed under the contracts and paid in connection with investments in underlying funds, including funds of funds, are fair and reasonable. We therefore believe that the certification requirement would be superfluous. We also believe this certification requirement would present significant burdens for insurance companies that are not affiliated with the fund of funds' manager, and funds of funds would have limited legal and business recourse to address these types of challenges.<sup>44</sup> In addition, the certification requirement would be incompatible with the SEC's goal of developing a more consistent, comprehensive rulemaking for fund of funds arrangements, as it would result in different obligations for funds of funds offered as underlying investment options in variable insurance contracts as compared to "retail" funds of funds. Accordingly, we strongly suggest that the SEC reconsider the proposed certification requirement and eliminate this requirement from any final rulemaking.

## **V. Acquired Fund Fees and Expenses Disclosure**

Under current disclosure requirements, an acquiring fund is required to disclose in its prospectus fee table the fees and expenses it incurs indirectly from investing in other funds. In response to the Commission's request for comments on these disclosures, we agree with the comments recently submitted by the Investment Company Institute that propose that funds be permitted to exclude BDC expenses from the line item acquired fund fees in a fund's prospectus fee table, which would enable BDCs to be treated similarly to other operating companies in which a fund may invest.<sup>45</sup>

## **VI. Conclusion**

We fully support the Commission's efforts to improve the existing regulatory structure in a way that ultimately benefits all investors. However, we believe the Commission's overall goals in making this Proposal can best be achieved if certain of our suggested changes to the Proposal are implemented. We believe that the Proposal imposes more burdens on funds of funds and their shareholders than the current framework. We also believe that the Proposal would have the unintended effect of eliminating many of the benefits offered to shareholders by existing funds of funds, disadvantaging fund of funds shareholders relative to other types of shareholders, and

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<sup>43</sup> The Proposed Rule would also require a fund of funds' manager (rather than its board of trustees/directors, as required under current SEC exemptive orders) to: (1) evaluate the aggregate fees associated with the underlying fund investment and the complexity of the fund of funds arrangement; and (2) determine that the underlying fund investment is in the best interests of the acquiring fund. See Proposed Rule 12d1-4(b)(3)(i).

<sup>44</sup> Although this condition is based on a condition of current exemptive relief for fund of funds arrangements, the scope of fund of funds that would be subject to the Proposed Rule would likely be broader than the scope of those funds that rely on the Section 12(d)(1) Orders (or Section 12(d)(1)(G)) because of other components of the Proposal, such as the rescission of Rule 12d1-2).

<sup>45</sup> See Letter from Susan Olson, General Counsel, Investment Company Institute to Brent Fields, Secretary, Securities and Exchange Commission (October 24, 2018) at , available at <https://www.sec.gov/comments/s7-12-18/s71218-4932121-178430.pdf> (regarding SEC's Request for Comment on Fund Retail Investor Experience and Disclosure (File No. S7-12-18)).

significantly reducing the viability of certain types of fund of funds structures due to disparate treatment under the Proposal. As such, we would encourage the Commission to consider certain changes to the Proposal, including the elimination of the Limited Redemption Provision and, if the Limited Redemption Provision is not eliminated, the preservation of Rule 12d1-2 and certain Section 12(d)(1) Orders. We hope that the Commission will carefully consider the issues that we have raised with respect to the Proposal.



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John Hancock Investments appreciates the opportunity to comment on the Proposed Rule and hopes that the Commission finds these comments helpful and constructive. If you wish to discuss these comments further, please contact Andrew G. Arnott, President & CEO of John Hancock Investments, at [REDACTED]; or Christopher Sechler, Vice President and Deputy Chief Counsel, at [REDACTED].

Sincerely,

/s/ Andrew G. Arnott

Andrew G. Arnott  
President & CEO  
John Hancock Investments

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