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INVESTMENT MANAGEMENT REGULATION**

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May 2, 2019

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

**Re: Fund of Funds Arrangements (Investment Company Act Release No. 33329  
(December 19, 2018)): File No. S7-27-18**

Dear Ms. Countryman:

This letter is submitted by the Committee on Investment Management Regulation of the New York City Bar Association (the “Committee”) and responds to the request of the Securities and Exchange Commission (the “Commission”) for comment in response to Investment Company Act Release No. 33329 (December 19, 2018) (the “Proposal” or “Proposing Release”), in which the Commission proposes to streamline and enhance the regulatory framework applicable to funds that invest in other funds (“fund of funds” arrangements) under the Investment Company Act of 1940, as amended (the “1940 Act”). The Committee is composed of lawyers with diverse perspectives on investment management issues, including attorneys from law firms and counsel to financial services firms, investment company complexes and investment advisers.

**Summary**

The Proposal contemplates the Commission’s adopting new Rule 12d1-4, rescinding existing Rule 12d1-2, amending existing Rule 12d1-1, rescinding many of the exemptive orders

granting relief from Sections 12(d)(1)(A), (B), (C), and (G) of the 1940 Act, and amending Form N-CEN. The Committee provides comment on certain aspects of the Proposal, as detailed below.

### Proposed Rule 12d1-4

#### Inclusion of Private Funds and Foreign Funds

Proposed Rule 12d1-4 (“Proposed Rule”) under the 1940 Act would expand the types of investment vehicles permitted to operate as acquiring funds and acquired funds in a fund of funds arrangement. The Proposal would, for example, allow 1940 Act-registered investment companies (“RICs”) and business development companies (“BDCs”) to act as “acquiring funds” and to acquire securities of other investment vehicles, including other RICs and BDCs. The Committee believes that this expansion of exemptive relief is appropriate and consistent with the public policy goals of Section 12(d)(1) of the 1940 Act.

While the Proposal would broaden the types of acquired funds in which acquiring funds could invest, as proposed, Rule 12d1-4 would not permit private funds<sup>1</sup> or foreign funds<sup>2</sup> to act as acquiring funds. As a result, private funds and foreign funds would be required to seek relief through the exemptive application process, as is currently the case. The Commission has requested comment on whether private funds and foreign funds should be permitted to rely on the Proposed Rule. The Committee suggests that the Commission expand the scope of the Proposed Rule to allow private funds and foreign funds to operate as acquiring funds without seeking separate relief.

#### Limited Redemption Condition

Under Proposed Rule 12d1-4(b)(2), an acquiring fund holding more than 3% of an acquired fund’s outstanding voting shares would be prohibited from redeeming more than 3% of that

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<sup>1</sup> A “private fund” is an issuer that would be an “investment company,” as defined in Section 3 of the 1940 Act, but for Sections 3(c)(1) or 3(c)(7) of that Act. Sections 3(c)(1) and 3(c)(7) provide that a private fund is nonetheless an “investment company” for purposes of the 3% limitation described in Sections 12(d)(1)(A)(i) and (B)(i), but only with respect to the private fund’s purchase of shares issued by any RIC or BDC and the sale of shares by any registered open-end fund to the private fund. For that reason, no more than 3% of the voting shares of a RIC or BDC may knowingly be purchased by, or sold to, a private fund (*i.e.*, the 5% and 10% limitations of Section 12(d)(1)(A) do not apply). Section 12(d)(1) does not limit a RIC’s or BDC’s purchase of shares of a private fund (although such investments may be illiquid for purposes of a RIC’s 15% limit on investments in illiquid investments under Rule 22e-4 under the 1940 Act).

<sup>2</sup> A “foreign fund” generally refers to an investment company that is organized outside the United States and that does not offer or sell its securities in the United States in connection with a public offering. The Commission has taken the position that a foreign fund that uses U.S. jurisdictional means in the private offering of its securities and that relies on Sections 3(c)(1) or 3(c)(7) would be a private fund. Proposing Release at 21, n. 52 (citing *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers*, Investment Advisers Act Release No. 3222 (Jun. 22, 2011)). Foreign funds that are not private funds are subject to the 3%/5%/10% limits in Section 12(d)(1)(A)(i)-(iii). However, the Commission staff has issued a number of no-action letters to permit fund of funds arrangements involving foreign funds in excess of these limits. See *Dechert LLP*, SEC No-Action Letter (Aug. 24, 2009) (the “2009 Dechert Letter”); *Dechert LLP*, SEC No-Action Letter (Mar. 8, 2017) (the “2017 Dechert Letter”).

acquired fund's shares in any 30-day period ("limited redemption condition"). The Commission has requested comment on, among other things, whether the limited redemption condition should be adopted (and if so, how should it be implemented), whether the limitation will affect the portfolio management of acquiring funds, and whether the limitation would cause acquiring funds to incur significant costs.

The Committee believes that the limited redemption condition should be eliminated because it would limit the flexibility of portfolio managers to efficiently manage funds and ultimately would serve to diminish investors' options. The Committee notes that the Proposed Rule would subject both affiliated and unaffiliated fund of funds arrangements to certain conditions despite the lack of a clear policy reason to impose such conditions on affiliated fund of funds arrangements. The Committee supports allowing an acquired fund to address the potential threat of large-scale redemptions through a redemption management agreement and related procedures, and the Committee notes that such procedures could allow some flexibility to permit redemptions beyond a certain limit, such as, for example, the need to satisfy acquiring fund shareholder redemption requests. Further, the Committee believes that imposing the limited redemption condition casts doubt on whether the security subject to the condition can still be considered a "redeemable security" for purposes of the 1940 Act.

#### Fees and Other Considerations: Best Interest Determination

Under Proposed Rule 12d1-4(b)(3), if the acquiring fund is a management investment company, the adviser to the acquiring fund must make a determination that investing in the acquired fund is in the best interest of the acquiring fund. The Proposal also details the frequency with which the adviser must make this determination and report to the acquiring fund's board of directors. The Commission has requested comment on whether a best interest determination should be required, whether the Commission should provide additional guidance regarding the adviser's best interest analysis, and what parameters should be placed on board oversight. The Committee suggests that the Commission replace the best interest determination requirement with guidance setting out the factors the Commission believes an adviser should consider before causing an acquiring fund to invest in an acquired fund. If the Commission retains the best interest determination in the final rule, the Committee believes that the Commission should eliminate the requirement that the adviser present its determination and the rationale therefor to the board of directors prior to a fund investing in another fund. Instead, any final rule should allow the adviser to present the determination to the board at the next regularly scheduled meeting.

#### Rescission of Rule 12d1-2

Rule 12d1-2 was designed to provide a fund relying on Section 12(d)(1)(G) with greater flexibility to meet its investment objective by complementing an acquiring fund's use of affiliated

funds.<sup>3</sup> The Commission has requested comment on whether Rule 12d1-2 should be rescinded and the effect of such rescission. The Committee believes the rescission of Rule 12d1-2 would eliminate the flexibility that the Commission intended acquiring funds relying on Section 12(d)(1)(G) to have and therefore recommends that the Commission retain Rule 12d1-2.

Rescission of Exemptive Orders, Withdrawal of No-Action Relief and Withdrawal of Interpretive Guidance

The Commission has proposed to rescind all exemptive orders granting relief from Sections 12(d)(1)(A), (B), (C), and (G) of the 1940 Act in order to streamline the oversight of fund of funds arrangements. The Commission requests comment on whether any funds currently relying on Rule 12d1-2 will face challenges in relying on the conditions in Proposed Rule 12d1-4. The Committee is concerned that broadly rescinding all exemptive orders pertaining to fund of funds arrangements will impose undue hardship on those entities relying on orders that do not fit neatly within the Proposed Rule. The Committee suggests that the Commission clarify the scope of exemptive orders that are subject to rescission, including whether only portions of existing orders will be rescinded. Further, the Committee emphasizes that the rescission of exemptive orders will disrupt long standing practices as fund companies have tailored their operations to individualized orders providing exemptive relief. As a result, the Committee suggests the Commission consider the significant effect of these changes as it evaluates the scope of orders to be rescinded and the timing of the transition period before compliance with Proposed Rule 12d1-4 is required. The Committee notes that the Commission's proposed approach to codifying exemptive relief in the Proposal appears inconsistent with its past approach and suggests that if the Commission decides to move forward with rescinding current relief that the Commission provide reasonable notice to the holders of those exemptive orders that will be affected. The Committee's view is that certain no-action letters should remain in place and, if some such letters are withdrawn, the Commission should incorporate the relief provided in such letters into the final rule.

The Committee appreciates that the primary purpose of the Commission in issuing the Proposal is to "create a consistent and efficient rules-based regime for the formation and oversight" of fund of funds arrangements.<sup>4</sup> However, the Committee has certain concerns with the Proposal and offers these responses to the Commission's request for comment.

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<sup>3</sup> Section 12(d)(1)(G) allows a registered open-end fund to acquire an unlimited amount of shares of an affiliated fund. An acquiring fund that relies on Section 12(d)(1)(G) is subject to a limitation on the types of non-fund securities it can hold to government securities and short-term paper (in addition to the shares of affiliated funds).

<sup>4</sup> Proposing Release at 6.

## **1. Proposed Rule 12d1-4**

### **a. Inclusion of Private Funds and Foreign Funds**

The Proposal questions whether it would be appropriate to permit private funds and foreign funds to rely on Proposed Rule 12d1-4 as acquiring funds due to regulatory concerns, including reporting, recordkeeping, and registration concerns.<sup>5</sup> Specifically, the Proposal highlights that private funds are not registered with the Commission, are not subject to reporting requirements (such as Form N-CEN) that would help evidence reliance on the Proposed Rule, are not required to report portfolio holdings on Form N-PORT, and are not subject to the 1940 Act recordkeeping requirements.<sup>6</sup> The Commission requests comment on whether the reporting regime for private funds and foreign funds is sufficiently robust to provide information that will address regulatory concerns underlying the Proposal. The Commission also requests comment regarding whether private funds and foreign funds should be required to make certain filings with the Commission disclosing their reliance on the Proposed Rule.

The Committee fully understands the Commission's concerns, but we believe the Proposal's approach is inconsistent with the broader statutory concerns underlying the limitations in Section 12(d) on fund of funds investments. The Committee's view is that the Proposal goes farther than necessary to address Congressional and historic Commission concerns at the expense of less restrictive alternatives. Congress' concerns associated with fund of funds structures, which dates back to the establishment of the 1940 Act, include the pyramiding of investment companies and resulting concentration of control.<sup>7</sup> In addition to concerns of acquiring funds exercising undue influence over acquired funds, Congress focused on the layering of fees and the formation of overly complex structures that would confuse investors. In a 1966 report, *Public Policy Implications of Investment Company Growth Report* ("PPI Report"), the Commission analyzed the same Congressional concerns discussed above (control, undue influence, duplicative costs, and unnecessary complexity of fund of funds structures without a clear benefit).<sup>8</sup> However, as discussed further below, certain of these concerns do not apply to foreign funds and private funds that operate as acquiring funds.

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<sup>5</sup> *Id.* at 19-20.

<sup>6</sup> *Id.*

<sup>7</sup> 1940 Act, Section 1(b)(4).

<sup>8</sup> The Commission noted specifically that: "The situation is more critical where the stockholders of the fund-holding company reside outside the United States since redemptions could be unduly escalated by the instability of certain foreign economies, political upheaval, currency reform, or other factors which are not really relevant to investment in domestic mutual funds. Should such redemptions occur, it is entirely likely that they would involve several foreign based holding companies at once. A number of the underlying funds in the portfolio of these fund holding companies would undoubtedly be the same—and many of the underlying securities held by such portfolio funds would also be duplicated and reduplicated." *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) ("PPI Report") at 318.

Despite reflecting the Commission's historic wariness of fund of funds structures, the Proposal recognizes the benefits of these structures more globally and notes that investors make extensive use of them to meet investment objectives, including asset allocation and diversification, and also to manage risk.<sup>9</sup> The Committee believes that permitting private funds and foreign funds to operate as acquiring funds under the Proposed Rule could benefit registered fund shareholders by increasing the scale of RICs, enhancing liquidity of RICs, increasing capital flow to the U.S. market, and expanding investment opportunities available to both U.S. and foreign investors. We request that the Commission consider whether the conditions already included in the Proposal<sup>10</sup> are sufficient to address its concerns as well as historical Congressional concerns regarding control and undue influence, particularly in light of the benefits from these investments. We note that, in the alternative, the less restrictive alternatives discussed below could address concerns relating to private and foreign funds investing in RICs above statutory limits.

The concerns in the 1940 Act regarding layered fees and duplicative costs are not nearly as prominent in the context of private funds and foreign funds today due to the investor base of these investment vehicles and the Commission's focus on U.S. investor protection, specifically the protection of U.S. retail investors. Given this focus, the Commission staff has previously, and we believe correctly, acknowledged the reduced regulatory interest in enforcing the provisions of Section 12(d)(1) for the protection of shareholders of foreign funds that do not offer or sell shares to U.S. persons, so long as the level of the foreign fund's investment are well below thresholds to exercise control.<sup>11</sup> As commenters pointed out, in response to the Commission's 2008 proposal regarding exchange-traded funds and fund of funds arrangements,<sup>12</sup> "private fund investors may be better able to understand the complex structure and judge the propriety of the private fund's fees than some investors in other types of acquiring funds."<sup>13</sup> Similarly, investors in private funds are required to meet certain sophistication criteria such that this group of investors is presumed to be capable of comprehending and understanding the implications of a layered fee structure. Further, the Commission, through enforcement, is able to address improper fee practices related to private funds and foreign funds with a U.S.-registered adviser.

The Commission asserts a lack of transparency of foreign fund of funds as cause for concern, and notes that such funds are subject to foreign privacy laws that may make it difficult to

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<sup>9</sup> Proposing Release at 7. To facilitate investor protection, FINRA has developed rules and provided guidance with respect to recommending complex products to investors, including with regard to sales practices and supervision requirements. *See, e.g.*, FINRA Rule 2111; *see also* FINRA Notice to Members 11-02 SEC Approves Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations (Jan. 2011); FINRA Notice to Members 11-25: New Implementation Date for and Additional Guidance on the Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations (May 2011).

<sup>10</sup> Proposing Release at 30-31.

<sup>11</sup> *See* 2009 Dechert Letter; *see infra* Section 3 for further discussion of the Commission staff's review of no-action letters.

<sup>12</sup> *Exchange-Traded Funds*, Investment Company Act Release No. 28193 (Mar. 11, 2008).

<sup>13</sup> Proposing Release at 19; *see also* Comment Letter of Managed Fund Association (May 19, 2017) and Comment Letter of State Street Global Advisors (May 19, 2008).

determine the control of U.S. RICs.<sup>14</sup> Notably, significantly more information is available about private funds, foreign funds, and their advisers since the PPI Report was issued in 1966 and since the 2008 ETF proposal due to enhanced reporting brought about by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). As discussed below, the current reporting regime for advisers to foreign and private funds would seem to address concerns about obtaining information about these investment vehicles and can be modified to address any perceived information gaps.

**(i) Control**

The statutory concerns embodied in Section 12(d)(1) regarding control and undue influence are intended to protect an acquired fund and its U.S. shareholders. The Committee suggests that allowing private funds and foreign funds to rely on the Proposed Rule should not pose control and undue influence risks to U.S. fund shareholders in light of the conditions of Rule 12d1-4, including the voting and control condition. Even if a private fund or foreign fund was to invest in a U.S. fund beyond the limits in Rule 12(d)(1)(A) in reliance on the Proposed Rule, the private fund or foreign fund would be prohibited under the Proposal from controlling the acquired fund and would be required to comply with certain voting restrictions that would prevent the acquiring fund from exerting undue influence over the acquired fund.<sup>15</sup> The latter condition would require an acquiring fund to either engage in pass through or mirror voting.<sup>16</sup>

In seeking to minimize the risks of acquiring fund control over an acquired fund without impeding the operation of a fund of funds arrangement, the Proposal appears to reject several less restrictive alternatives. These alternatives to prohibiting private funds and foreign funds from relying on the Proposed Rule would permit a private or foreign fund to invest in a registered fund above the limits in Section 12(d)(1)(A) while still addressing the investor protection concerns in the 1940 Act and further reflected in the PPI Report. Notably, while both foreign funds and private funds pose different regulatory challenges due to their structure and investor base, both are subject to significantly more regulation than they were at the time the 1966 PPI Report was issued and when the last fund of funds rule proposal was issued in 2008. The Committee believes that the current regulatory requirements imposed on private funds and on advisers to private funds and foreign funds afford sufficient protection to address the concerns raised above, but that, if the Commission believes that additional regulation is required to address the issue of an acquiring fund’s controlling an acquired fund, the Commission should consider the alternatives below.

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<sup>14</sup> PPI Report at 323; *see also* PPI Report at n. 42.

<sup>15</sup> Proposed Rule 12d1-4(b)(1).

<sup>16</sup> The Committee notes mirror voting may be more appropriate for private and foreign funds.

**(ii) Less Restrictive Alternatives to Address Concerns Regarding Control and Undue Influence**

While not advocating for any particular approach, and not conceding that any additional regulation is necessary to address the concerns of control and undue influence cited by the Commission in the Proposing Release, the Committee believes that the following alternatives to a complete prohibition on private funds and foreign funds relying on the Proposed Rule should be considered by the Commission. These alternatives, either individually or in combination, could be used to further protect registered fund shareholders from a less regulated fund's gaining control of a registered investment company.

First, private funds and foreign funds seeking to rely on the Proposed Rule can enter into negotiated agreements in which the acquiring fund makes certain representations regarding the extent of its control and influence over the acquired fund. Requiring such an agreement would allow the U.S.-registered underlying fund to choose whether to accept a private or foreign fund investment and could provide a more flexible approach that can work for both foreign and private funds, despite their unique structures, investors, and associated regulatory concerns.<sup>17</sup>

Second, the Commission could enhance existing reporting, to the extent necessary, on forms that advisers to private funds and foreign funds are already required to complete, namely Forms ADV and PF. Certain information about a private fund's regulatory compliance, general holdings information, and performance is already filed with the Commission through Forms ADV and PF. Certain of this information is publicly available to investors, including most information filed on Form ADV. Under the Dodd-Frank Act, an increasing number of private fund advisers are registered with the Commission. As a result, the Commission now has access to more private fund data than the information available at the time the PPI Report was issued and other amendments to Section 12(d)(1) and related rules were considered.<sup>18</sup> Notably, information reported on Form PF is not public and the form does not require disclosure of specific investments (e.g., names of portfolio companies) of the fund. Form ADV requires an adviser to disclose information including whether the private fund is a fund of funds, whether the private fund invests in a RIC, the percentage of the private fund owned by fund of funds, and percentage ownership of the private fund by non-U.S. persons. Like Form PF, Form ADV does not require detailed disclosure of private fund portfolio holdings.

If the Commission believes further enhancements to a private fund and/or foreign fund's reporting regime are necessary, the Commission could require private funds and foreign funds that seek to rely on the Proposed Rule for the purposes of owning more than 3% of an acquired fund

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<sup>17</sup> The Committee acknowledges the Commission's concerns regarding the use of negotiated agreements for registered fund of funds arrangements, but suggests that a more tailored use of agreements by private and foreign funds could be made a central component of an effective regulatory approach to fund of funds investment structures.

<sup>18</sup> Securities and Exchange Commission, Private Fund Adviser Overview, *available at* <https://www.sec.gov/divisions/investment/guidance/private-fund-adviser-resources.htm> (last accessed Apr. 1, 2019). (All websites cited in this letter were last visited on May 2, 2019.)



to file with the Commission a statement indicating reliance on the Proposed Rule as well as other reporting that would enhance information currently available through Forms ADV and PF. Private funds and foreign funds seeking to rely on the Proposed Rule could be required, for example, to submit information similar to that required in Part C of Form N-PORT.

We note that Form ADV currently provides information about a private fund's foreign regulators, country of origin, and percentage ownership of the private fund by non-U.S. persons. The Commission could also require, with respect to funds advised by a non-U.S. adviser, that the foreign fund agree to submit to U.S. jurisdiction and submit certain portfolio holding reports to the Commission if the foreign fund seeks to rely on the Proposed Rule when investing in an acquired fund beyond the 3% limit. Such reports could be designed to solicit information on the control issues raised in the PPI Report (*i.e.*, control of the acquired fund as well as control over portfolio companies in the acquired fund).<sup>19</sup>

Third, the Commission could exercise its rulemaking authority with regard to advisers to private funds and foreign funds that, in the Commission's view, do not currently report sufficient information.<sup>20</sup>

The Committee recognizes that substantially less information is likely available to the Commission and/or U.S. investors with respect to foreign funds that are not making an offering in the United States and do not have a U.S.-registered adviser. We submit that the Commission's staff has appropriately addressed such situations in previously issued no-action letters. In particular, the staff has permitted foreign funds to act as acquiring funds and to invest in U.S. RICs, subject to conditions and limitations detailed in those letters (most notably the 3% limit).<sup>21</sup> Based on the knowledge and experience of the Committee's members, private and foreign funds regularly seek to rely on these letters. To the extent that a foreign fund seeks to invest in a U.S.-registered fund above the Section 12(d)(1)(A) limits, the Committee suggests that maintaining the 3% ownership limit in the staff's letters addresses the applicable statutory concerns and that these letters should be maintained following the final adoption of the Proposal. To the extent that a foreign fund seeks to exceed this 3% limit, the Commission could consider the use of additional tailored information or conditions to address those concerns.

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<sup>19</sup> PPI Report at 317.

<sup>20</sup> See, e.g., Sections 203(l) and 203(m) of the Investment Advisers Act of 1940, as amended.

<sup>21</sup> See *Principal Investors Fund, Inc.*, SEC No-Action Letter (May 13, 2005), *Frank Russell Investment Co.*, SEC No-Action Letter (Oct. 20, 1986) and *Millenia II*, SEC No-Action Letter (Jan. 24, 1992); see also 2009 Dechert Letter (stating that the Commission staff would not recommend enforcement action to the Commission against foreign funds under Sections 12(d)(1)(A)(ii) and (iii) if foreign funds purchase securities issued by U.S. investment companies registered under the 1940 Act in excess of the limits imposed by Sections 12(d)(1)(A)(ii) and (iii), provided that certain conditions are satisfied). To exclude foreign funds from Proposed Rule 12d1-4 without providing further guidance on the status of no-action relief currently available to foreign funds or on the requirements that foreign funds would need to satisfy to take advantage of Proposed Rule 12d1-4, leaves foreign funds in a difficult position. See *infra* Section 3 for further discussion of the Commission staff's review of no-action letters.

**b. Conditions**

**(i) Limited Redemption Condition**

**(1) Effects of the Limited Redemption Condition on Fund of Funds Arrangements**

Proposed Rule 12d1-4(b)(2), if adopted, would prohibit an acquiring fund that acquires more than 3% of an acquired fund's outstanding shares from redeeming more than 3% of the acquired fund's total outstanding shares in any 30-day period in which the acquiring fund owns more than 3% of the acquired fund's shares. The Commission has proposed the limited redemption condition to address concerns that an acquiring fund could threaten large-scale redemptions to exercise undue influence over an acquired fund. The Proposed Rule is intended to provide a check against the influence that an acquiring fund can have on an acquired fund when it owns a significant percentage of the acquired fund.<sup>22</sup> The Commission has requested comment on, among other things, whether the limited redemption condition should be adopted and, if so, how it should be implemented.<sup>23</sup> The Committee strongly believes on the basis of the collective experience of its members that the limited redemption condition would, if adopted, have a number of negative effects, described below, on fund of funds and their shareholders.

**a. The Limited Redemption Condition Would Severely Limit Portfolio Manager Flexibility and Render Many Fund of Funds Arrangements Unworkable**

The limited redemption condition, if adopted, would severely limit the flexibility necessary for portfolio managers of fund of funds to manage their portfolios and would ultimately render many current fund of funds arrangements unworkable. Such a condition is not currently imposed on fund of funds relying on the Section 12(d)(1)(G) exception to the holdings limitations under Section 12(d)(1)(A); nor is it a condition in current exemptive orders.<sup>24</sup> In short, fund of funds have historically provided their investors with an important investment option for efficiently gaining investment exposure without the restrictions of such a condition.

The Committee is aware of a small number of older orders that contained a similar condition limiting acquiring fund redemptions to 1% of an acquired fund's total outstanding securities in any period of less than 30 days.<sup>25</sup> However, in superseding orders, the Commission

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<sup>22</sup> Proposing Release at 47-48.

<sup>23</sup> *Id.* at 53-59.

<sup>24</sup> *Id.* at 48.

<sup>25</sup> See *T. Rowe Price Spectrum Fund, Inc., et al., Notice of Application*, Investment Company Act Release No. 17198 (Oct. 31, 1989) (notice) (the "1989 T. Rowe Price Notice") and 17242 (Nov. 29, 1989) (order); *T. Rowe Price Spectrum Fund, Inc., et al., Amended and Restated Application*, SEC File No. 812-9266 (Aug. 23, 1995) (the "1995 T. Rowe Price Amended and Restated Application"); *Norwest Bank Minnesota, N.A., et al., Notice of Application*, Investment Company Act Release No. 20640 (Oct. 19, 1994) (notice) and 20697 (Nov. 10, 1994) (order); *Norwest Bank Minnesota, N.A., et al., Second Amended Application*, SEC File No. 812-10040 (Jun. 27, 1996) (the "1996 Norwest Bank Second Amended Application"). The 1989 T. Rowe Price Notice contained the following condition: "Redemptions from any Underlying Fund [acquired fund] by Spectrum Fund [acquiring fund] will be limited to 1% of the Underlying Fund's assets in any period of less than 30 days, except where necessary to meet Spectrum Fund shareholder redemption requests." In 1995, T. Rowe's order was superseded and this condition was removed. A 1994

agreed to relieve those applicants of the burdens of complying with such a condition. In seeking amended orders, applicants advocated for removal of the historical condition limiting redemptions, taking the position that (i) removing the condition would provide flexibility to portfolio managers and facilitate “prudent investment management” while ensuring that investors were protected,<sup>26</sup> (ii) the condition was not contained in more contemporary fund of funds relief,<sup>27</sup> and (iii) the Commission had growing experience regulating fund of funds structures since the initial relief was granted.<sup>28</sup> That exemptive relief issued nearly 30 years ago was conditioned on a requirement that was never adopted on a widespread basis and subsequently eliminated, the Committee submits, supports the view that such a similar condition should not be resurrected as part of Proposed Rule 12d1-4. We believe such a condition essentially reverses the product innovation and regulatory progress that the industry and Commission, respectively, have since made in efficiently operating and regulating fund of funds arrangements and could impede prudent investment management.

As the Committee recommends further below, we believe the limited redemption condition should be eliminated. In at least one instance in which the 1% redemption limit was included in a small subset of prior orders, the Commission still recognized the need for flexibility in the condition to allow for redemptions beyond the 1% limit to satisfy the redemption requests of shareholders of the acquiring fund.<sup>29</sup> Should the Commission wish to retain the limited redemption condition as part of Proposed Rule 12d1-4, the Committee believes the Commission should, at a minimum, permit an exception to the condition to facilitate redemption requests of acquiring fund shareholders, which would benefit investors and facilitate liquidity management of the acquiring fund. We believe such an exception would also be consistent with the spirit of the 1940 Act’s “redeemable security” definition as discussed below.

Fund of funds serve their investors by providing them with a one-stop investment resource for market exposure and risk mitigation through broad portfolio diversification executed in a cost-efficient manner.<sup>30</sup> The limited redemption condition would significantly inhibit the execution of

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notice filed in connection with Norwest Bank Minnesota, N.A.’s request for relief contained the following condition: “Each Blended Balanced Fund [acquiring fund] will limit any redemptions resulting from a reallocation in its equity and fixed income positions to no more than 1 percent of a Portfolio’s [acquired fund] total outstanding securities during any period of less than thirty days.” The condition was originally imposed to “insure that no significant redemptions in the Core Trust Portfolios [acquired funds] will occur as a result of reallocations.” In 1996, Norwest was granted superseding exemptive relief and this condition was removed.

<sup>26</sup> *Id.* at 21-22; *see also* 1995 T. Rowe Price Amended and Restated Application at 11.

<sup>27</sup> *See* 1996 Norwest Bank Second Amended Application at 5.

<sup>28</sup> *Id.*

<sup>29</sup> T. Rowe’s initial exemptive relief provided: “Redemptions from any Underlying Fund by Spectrum Fund will be limited to 1% of the Underlying Fund’s assets in any period of less than 30 days, *except where necessary to meet Spectrum Fund shareholder redemption requests.*” (emphasis added) 1989 T. Rowe Price Notice.

<sup>30</sup> Asset-allocation funds are able to re-allocate exposure to asset classes relatively quickly by increasing or decreasing exposure to underlying funds, thereby gaining efficiency by avoiding the need to conduct voluminous individual securities transactions. *See, e.g.*, Eaton Vance Tax-Managed Equity Asset Allocation Fund, prospectus dated Mar. 1, 2018 (Describing a fund of funds with broad discretion to allocate and reallocate assets among underlying portfolios and other investments consistent with the Fund’s investment objective and policies. The portfolio managers seek to maintain broad diversification and to emphasize market sectors that Eaton Vance believes offer relatively attractive risk-adjusted return). There are many other uses of fund of funds arrangements, including equitizing cash, hedging, and risk-management. Statement of Commissioner Kara Stein, Open Meeting on Proposed Rule 12d1-4 under the

many fund of funds' investment strategies and techniques – and ultimately the successful pursuit of their investment objectives – by preventing an acquiring fund from efficiently reallocating assets across its underlying acquired funds and other non-fund investments, rebalancing its portfolio consistent with its strategy, and managing its ability to meet redemption requests.

Portfolio managers of acquiring funds typically select acquired funds based on the type of investment exposure desired, not the acquired fund's asset size. As a result, an acquiring fund may routinely own more than 3% of one or more acquired funds. It is not uncommon in those cases for a redemption request to exceed 3% in any 30-day period as a result of, among other things, large redemptions out of the acquiring fund or the acquiring fund's need to reallocate assets across investments in underlying acquired funds or other non-fund investments in response to changing market conditions or in facilitating rebalancing programs. The limited redemption condition's threshold of 3% would run contrary to this rather commonplace investment pattern and would require a portfolio manager of a fund of funds to factor into its investment allocation model the desired acquired fund's asset size for purely mathematical reasons. In operating in this manner, the limited redemption condition has the potential to force portfolio managers seeking to avoid noncompliance with the Proposed Rule to select underlying funds that they would not otherwise choose in seeking to meet investment goals, as the size of such an acquired fund would be more accommodating to larger redemptions than smaller funds that may be more optimally-suited to the acquiring fund's investment goals. Not only could this sort of result be detrimental to investors in acquiring funds, but the limited redemption condition could also have the unintended consequence of creating a competitive disadvantage for relatively smaller underlying funds, particularly those offered by smaller-to-medium sized fund complexes, an issue about which senior level Commission staff have recently expressed concern.<sup>31</sup>

The Committee suggests, with regard to multi-tier arrangements, that the Commission clarify Proposed Rule 12d1-4(b)(4)(iii)(B) by removing the phrase “short-term cash management purposes.” Inclusion of the phrase introduces ambiguity as it is not included in Rule 12d1-1 and is not defined in the Proposed Rule. The Proposed Rule should instead clearly indicate that multi-tier structures are permitted when acquired funds invest in money market funds.

Another negative effect of the limited redemption condition is that it could make it difficult for a fund of funds to quickly and efficiently replace an underlying acquired fund in which it has a significant investment in a case in which the fund of funds' portfolio manager needs to act quickly, such as when market conditions change rapidly or when an underlying fund announces a liquidation, change in investment objective or strategy, change in the portfolio management team, or any other change that would typically be implemented in a relatively short timeframe. The Commission acknowledged this potential consequence in the Proposing Release when it estimated that it “could take up to 10 months for an acquiring fund that fully unwinds its investment in an acquired fund, if that fund holds 25% of the outstanding shares of the acquired fund (*i.e.*, up to the

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Investment Company Act of 1940 Governing Fund of Funds Arrangements (Dec. 19, 2019), *available at* <https://www.sec.gov/news/public-statement/statement-stein-2018-12-19-fund-funds>. *See also infra* n. 65 and n. 67-70.

<sup>31</sup> *See, e.g.*, speech by Dalia Blass, Director of the Commission's Division of Investment Management (ICI Mutual Funds and Investment Management Conference, Mar. 2019).

control limit), and must comply with the Proposed Rule's 3% redemption limit."<sup>32</sup> Such a scenario is generally unworkable for many fund of funds and could potentially severely affect the fund's performance and its overall investment strategies.

The limited redemption condition would appear to be quite burdensome to implement. The limitation places the burden of monitoring the 3% threshold on the acquiring fund, which is unlikely to have access to real time information about the acquired fund's shares outstanding. Implementation of real-time tracking procedures/process could represent a significant cost for acquiring funds, and reliable real-time tracking would be especially difficult to achieve in circumstances in which the acquiring fund is not affiliated with the acquired fund. The Committee suggests that, to the extent the proposed 3% limit is retained in the final rule, the Commission consider replacing real-time tracking by allowing acquiring funds to calculate compliance with the limited redemption condition by relying upon the number of outstanding shares listed in an acquired fund's most recently published financial statements.

Proposed Rule 12d1-4(b)(2) makes no distinction between affiliated and non-affiliated funds for purposes of the limited redemption condition, with the result that arrangements involving both types of funds would be subject to the Proposed Rule. This treatment is in stark contrast to the current Section 12(d)(1)(G) framework. Under that framework, an arrangement between an affiliated acquiring and acquired fund relying on Section 12(d)(1)(G) is not subject to the same percentage and time interval conditions imposed by the limited redemption condition (so long as the affiliated acquired fund is open-end).

An affiliated fund of funds arrangement undertaken in accordance with Section 12(d)(1)(G) does not implicate the public policy concerns underlying Section 12(d)(1)(A) regarding undue influence of the acquiring fund over its underlying acquired fund because the acquiring fund is part of the same family of funds as the acquired fund, and each is served by common fiduciaries that owe the same duties to all of the funds under their oversight and management. An affiliated fund's investment adviser and portfolio manager would typically coordinate investing activities to manage redemptions at both the acquiring and acquired fund levels. The coordination of investing activities among affiliated funds is often embedded within advisers' procedures governing fund of funds arrangements and has been a key feature of those arrangements under the Section 12(d)(1)(G) framework. The Committee is at a loss to understand what policy purpose would be served by imposing the limited redemption condition on affiliated fund of funds arrangements under the Proposal.

A fund of funds investing beyond 3% in *non-affiliated* funds that is unable to execute its investment strategies or otherwise manage its portfolio efficiently under the limited redemption condition would be faced with the options of either (i) modifying its investment strategies and techniques in seeking to comply with the Proposed Rule; (ii) restructuring its investment strategies to be an affiliated fund of funds arrangement in reliance on Section 12(d)(1)(G) (which reliance would necessarily require the acquiring fund to reduce its exposure to the strategies, markets, asset classes, and techniques to which the non-affiliated underlying funds would provide access, in the

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<sup>32</sup> Proposing Release at 119, n. 260 and accompanying text.

process potentially significantly acting to the detriment of the fund's investors); or more simply (iii) liquidating.

If adopted, the limited redemption condition would have the effect of imposing a one-size-fits-all redemption policy across all fund of funds arrangements. Imposing such an approach implicitly assumes with respect to redemption management that all fund of funds arrangements are premised on the same investment strategies and the same reallocation and rebalancing models.<sup>33</sup>

**b. The Limited Redemption Condition Should be Eliminated in Favor of a Rule that Provides for Redemption Management Procedures at the Acquired Fund, and that is Otherwise Inapplicable to Affiliated Fund of Funds Arrangements; Other Suggestions the Commission Should Consider**

For the reasons discussed above, the Committee believes that the limited redemption condition should be eliminated entirely from the Proposal because it would unduly limit the flexibility of portfolio managers to manage their funds efficiently and could ultimately lead to diminished investor options in the marketplace. The Committee believes that, to the extent the Commission concludes such a limitation should be an element of the final rule, the limitation should apply *only to non-affiliated fund of funds arrangements* and must be workable for both acquiring and acquired funds without adversely affecting the portfolio management of either. The Committee also believes such a rule should be relatively straightforward, easily understood and implemented, and objectively testable within fund compliance programs. The Committee believes the overarching goals of such a rule should:

1. Adequately address the Commission's concerns regarding the exercise of undue influence by an acquiring fund or its affiliated persons by way of threat of large-scale redemptions;
2. Provide acquiring fund portfolio managers with the flexibility to execute on the fund's investment strategy efficiently (*e.g.*, asset allocation across affiliated, non-affiliated and non-fund assets, rebalancing, cash equitization, risk management, etc.) in pursuit of its investment objective and to manage redemptions; and
3. Provide acquired fund portfolio managers with the discretion and flexibility to manage redemptions in a manner that a fund's particular investment strategy, size, risk parameters, liquidity, and client service needs can comfortably sustain.

The Committee believes that short of eliminating the limited redemption condition, the best way to achieve the above goals would be to require an acquiring fund that desires to be able to invest an amount that may exceed 3% of the securities of the acquired fund to enter into a redemption management agreement with the acquired fund. The redemption management agreement would take into account the liquidity requirements of the acquired fund as well as those of the acquiring fund, and would also require the acquired fund to implement procedures to

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<sup>33</sup> Fund of funds arrangements generally tend to be designed to service particular investor needs. A rule that imposes a specified percentage ceiling limitation and specified time interval across the industry would seem not to take this business reality into account.

effectuate the redemption management agreements into which it has entered. By allowing an acquired fund to determine for its own uniquely specific portfolio the most effective combination of conditions, triggers, and other criteria it can use to manage large redemptions, a fund making itself available as an underlying fund in a fund of funds arrangement can construct the optimal mix of, for example, consent to a redemption management agreement, a percentage limitation, time interval, advance notification of redemption requests, and redemption glide-pathing, to strike an appropriate and mutually workable balance between protecting the acquired fund from undue influence, accommodating acquiring funds' redemption requests, and managing liquidity.<sup>34</sup> Under such a rule, an acquired fund could amend its current fund of funds procedures (in cases in which a fund has them) or establish procedures. In this regard, the Commission should consider whether the best way to implement such a rule is as a revised condition of the Proposal or as an amendment to current Rule 22e-4.<sup>35</sup>

Redemption management procedures would be based on an analysis by fund management of the fund's investment strategy, historical redemptions, asset size and projected growth, risk parameters, liquidity, and client service needs.<sup>36</sup> The Committee believes it would not be unreasonable for such procedures (i) to require agreement by an acquiring fund to the terms of a redemption management agreement with the acquired fund, and be subject to the acquired fund's redemption management procedures (which would be designed to strike the right balance between protecting the acquired fund and accommodating the acquiring funds' redemption requests); and to also include, if deemed appropriate, (ii) a maximum percentage amount beyond which an acquiring fund may not invest, and (iii) a provision that redemptions be requested subject to certain conditions that can assist in facilitating management of those redemptions, *e.g.*, redemptions

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<sup>34</sup> See, *e.g.*, *Templeton Growth and Treasury Trust, Series I and Subsequent Series, et al.*, Notice of Application, Investment Company Act Release No. 17336 (Feb. 12, 1990) (threat of large-scale redemptions is alleviated by agreeing to: (a) permit the acquiring fund to sell acquired fund shares only when necessary to meet redemption obligations or expenses; (b) limit the amount of any one acquired fund's shares that may be deposited into an acquiring fund; and (c) require acquiring funds' maturity dates to be at least 30 days apart from one another); *Kemper Investment Trust Series I and Subsequent Series, et al.*, Notice of Application, Investment Company Act Release No. 14941 (Feb. 14, 1986) (to reduce threats of large-scale redemptions, applicants sought to impose requirement that no acquiring fund could acquire more than 10% of the outstanding shares of the acquired fund, and undertook that not more than 10% of an acquired fund's shares would be deposited in multiple acquiring funds that are series of the same trust having zero-coupon obligations that mature within a 30-day period).

<sup>35</sup> As indicated above, the Commission's intent with the limited redemption condition is to mitigate the risk of large-scale redemptions used for the purpose of exercising undue influence. The purpose of the liquidity risk management program mandated by Rule 22e-4 is to "promote effective liquidity risk management." *Investment Company Liquidity Risk Management Programs*, Investment Company Act Release No. 32315 (Oct. 13, 2016) (the "Liquidity Rule Adopting Release") at 4.

<sup>36</sup> These criteria are not exhaustive. For example, in a 1995 T. Rowe Price application for exemptive relief, the applicants agreed to provide certain information directly to the Commission's Division of Investment Management including, among other things, monthly average total assets for each acquiring fund and each of the funds' underlying funds, monthly purchases and redemptions for each acquired fund and each of the funds' underlying funds, monthly exchanges into and out of each acquired fund of funds. See *T. Rowe Price Spectrum Fund, Inc., et al.*, Notice of Application, Investment Company Act Release No. 21371 (Sept. 22, 1995).

The Committee notes that a fund's portfolio management, risk, compliance and other internal teams are best situated to determine what criteria should be analyzed for that particular fund.

necessary to satisfy shareholder redemptions out of the acquiring fund;<sup>37</sup> advance notice to the acquired fund of impending redemptions; a redemption glide path; or some certain intervals. To assist with creating the consistency and harmony it seeks across all industry fund of funds arrangements, the Commission could consider providing fund companies with guidelines concerning the suggested procedures.

The Proposing Release indicates that the Commission considered a permissive approach, but determined that a mandatory rule is a more effective means to mitigate the threat of undue influence, reasoning that an acquiring fund could influence an acquired fund to eliminate (or never establish) a limit on redemptions if the redemption condition was merely permissive.<sup>38</sup> The Committee believes the approach described above minimizes that risk. The suggested approach would also serve the Commission's purpose of creating consistency and harmony across the industry; it is relatively straightforward, easily understood, easily implemented, trackable between the parties to the redemption management agreement, and should be easily testable within an acquired fund's compliance program. Furthermore, because it is an arm's length agreement between the parties, negotiation of the terms should provide reasonable assurance that an acquiring fund would not be able to influence an acquired fund to eliminate, or not establish, a limit on redemptions.

The Committee notes that an approach of the sort described above should be subject to an exemption. In particular, exempted from this approach should be closed-end interval funds subject to Rule 23c-3<sup>39</sup> and redemptions from underlying acquired funds that have announced a liquidation.

Should the Commission determine that a rule like the one described above would not effectively mitigate the threat of undue influence, it could consider in the alternative implementing reasonable parameters within the permissive rule (*e.g.*, allow a redemption ceiling of no more than some certain, more flexible percentage every certain interval of days). Short of the above considerations, the Commission should seriously consider, at least, the following, either individually or in some combination: raising the percentage threshold, reducing the number of days within which a fund can redeem at a certain percentage, creating an exception that would allow redemptions from an acquired fund beyond the 3% limit in scenarios when redemptions are to satisfy shareholder redemption requests at the acquiring fund level,<sup>40</sup> and creating an exception that would allow redemptions from an acquiring fund in a fund of funds arrangement in cases in which the acquiring fund holds more than 3% of an acquired fund's shares to be paid beyond the seven-day requirement imposed under the 1940 Act. The Commission could also consider implementation of a rule under which the acquiring fund is required to provide the acquired fund with a form of advanced notice of redemptions beyond a certain percentage.

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<sup>37</sup> See 1989 T. Rowe Price Notice.

<sup>38</sup> Proposing Release at 52.

<sup>39</sup> Rule 23c-3 under the 1940 Act requires an interval fund to adopt a fundamental policy to repurchase its shares on a periodic basis. The board determines the purchase amount, which the rule requires to be no less than 5% and no more than 25% of a fund's outstanding shares.

<sup>40</sup> See *supra* n. 32 and accompanying text.



## (2) The Limited Redemption Condition Conflicts with the Definition of “Redeemable Security”

The Committee believes that separate and distinct from the portfolio management and shareholder effects discussed above, the imposition of the limited redemption condition would call into a question whether the acquired fund would be offering a “redeemable security” within the meaning of the 1940 Act, that is, a security that “upon its presentation to the issuer . . . [entitles the holder] to receive approximately his proportionate share of the issuer’s current net assets, or the cash equivalent thereof.”<sup>41</sup> If an acquiring fund’s ability to redeem acquired fund shares would be subject to the limited redemption condition, an inherent tension would appear to exist between the limited redemption condition and Sections 2(a)(32) and 22(e) of the 1940 Act.

The legislative history underlying the 1940 Act appears to be clear and direct on the question of Congress’ intent with respect to the redemption right provided by open-end funds. Congress intended that an investor’s rights to receive proceeds upon the redemption of an open-end fund security be sacrosanct. In the adopting release to Rule 22e-4 under the 1940 Act, the Commission quoted a Senate report that stated, “[a redeemable security] is, a security which provides that the holder may tender it to the company at any time and receive a sum of money approximating the current market value...”<sup>42</sup> The Commission went on to say in the same adopting release that, “Section 2(a)(32) of the Act, when read together with [certain other sections of the 1940 Act] creates an *obligation* on open-end funds . . . to provide shareholders with approximately their proportionate share of NAV upon the presentation of a redemption request.”<sup>43</sup> In a contemporaneous House Committee hearing,<sup>44</sup> then Commissioner Robert Healey observed: “[t]he peculiarity of open-end companies is that they issue so-called redeemable securities—that is, a security which provides that the holder may tender it to the company at any time and receive a sum of money roughly proportionate to the current market value...”<sup>45</sup>

The Committee believes the limited redemption condition would fundamentally alter the terms of the security held by the acquiring fund to the extent it is part of an acquiring fund’s holding of acquired fund shares in excess of 3% within a 30-day period. Under the limited redemption condition, if an acquired fund held an amount of shares above the 3% threshold, the Commission’s redemption limit approach would render the security no longer “redeemable,” *i.e.*, it would not be a security that can be tendered for its value “at any time.” The Committee understands Congress’ intent in defining a “redeemable security” to mean that a shareholder, acquiring fund or otherwise,

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<sup>41</sup> 1940 Act, Section 2(a)(32).

<sup>42</sup> Liquidity Rule Adopting Release at n. 24, quoting *Investment Trusts and Investment Companies*: Senate Report 1775 on S. 4108, 76th Cong., 3d Sess. (1940), at 2 (emphasis added).

<sup>43</sup> *Id.* at 16.

<sup>44</sup> *Investment Trusts and Investment Companies: Hearings before a Subcomm. of the Comm. on Interstate and Foreign Commerce of the House of Representatives*, 76th Cong., 3d Sess. (Jun. 13 and 14, 1940).

<sup>45</sup> *Statement of Commissioner Robert E. Healy before a Subcomm. of Comm. on Banking and Currency on Wagner-Lea Act, S. 3580, to Regulate Investment Trusts and Investment Companies* (Apr. 2, 1940).

should be able to tender for monetary value the entire holding of its securities at “any time.” Given Congress’ intent and the statutory language relating to the definition of a “redeemable security,” the Committee respectfully submits that the Commission should give serious consideration to whether the limited redemption condition may exceed the scope of the Commission’s rule-making authority, as the Committee believes it conflicts with Congressional intent and the statutory language of the 1940 Act.

The Commission aims to reconcile the inherent tension between the limited redemption condition and the Congressional intent embedded in Sections 2(a)(32) and 22(e) of the 1940 Act by “prohibit[ing] an *acquiring* fund that acquires more than 3% of an acquired fund’s outstanding shares (*i.e.*, the statutory limit) from *redeeming or submitting for redemption, or tendering for repurchase*, more than 3% of an acquired fund’s total outstanding shares in any 30-day period.” The Commission’s rationale appears to be that by making the *acquiring* fund subject to the prohibition on “submitting for redemption” a request to redeem, instead of prohibiting the acquired fund from paying the proceeds in a timely manner, it places the condition on firm statutory ground.<sup>46</sup> The Committee appreciates the distinction the Commission makes between the acquiring fund’s “redeeming, or submitting for redemption, or tendering for repurchase” acquired fund shares beyond the limited redemption condition *and* the Section 22(e) prohibition on the *acquired* fund “suspend[ing] the right of redemption, or postpon[ing] the date of payment or satisfaction upon redemption of any redeemable security,” but questions whether the distinction is one having no difference when viewed through the lens of Congressional intent.

### **(3) The Limited Redemption Condition is Incompatible with Rule 22e-4**

The Commission has indicated that Proposed Rule 12d1-4 contemplates that acquiring funds that hold more than 3% of an acquired fund’s total outstanding shares would need to take the limited redemption condition into account when classifying their investment as part of their liquidity risk management program under Rule 22e-4.<sup>47</sup> The Commission requests comment on whether the limited redemption condition affects an acquiring fund’s liquidity risk management.<sup>48</sup> The Committee’s view is that the limited redemption condition is incompatible with the recently adopted liquidity risk management requirements under Rule 22e-4.

The purpose of Rule 22e-4 is to present the Commission and shareholders with an accurate picture of a registered fund’s liquidity risk. The limited redemption condition would seem

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<sup>46</sup> See Proposing Release at 47, n. 115 and accompanying text. (“Since the proposed condition *restricts an acquiring fund’s ability to redeem or submit a redemption request, rather than an acquired fund’s obligation to honor such redemptions*, we do not propose an exemption from [S]ection 22(e) of the Act in connection with this condition”) (emphasis added).

<sup>47</sup> See Liquidity Rule Adopting Release; *see also* Proposing Release at 51, n. 128. Rule 22e-4 requires, a fund to classify each of its portfolio investments into one of four liquidity categories – “highly liquid investments,” “moderately liquid investments,” “less liquid investments,” and “illiquid investments” – based on the number of days within which the fund can reasonably expect an investment to be convertible to cash (or, for the “less-liquid” and “illiquid” categories, sold or disposed of), without significantly changing the market value of the investment.

<sup>48</sup> Proposing Release at 55.

effectively at cross-purposes with the liquidity risk management provisions and goal of Rule 22e-4. Fund sponsors having fund of funds arrangements would be required, in meeting the terms and conditions of Proposed Rule 12d1-4, to assume additional burdens as they would need to integrate the limited redemption condition into those programs. The Committee submits that limiting the ability of acquiring funds to redeem their interests in acquired funds would inhibit, rather than facilitate, fund liquidity. The Committee believes that locking up liquidity in the fund of funds context would not align with the regulatory purposes supporting Rule 22e-4. The Committee requests that, at a minimum should the Commission adopt the limited redemption condition, that the Commission provide guidance on the types of considerations that would be appropriate (*i.e.*, how and when to factor in the limited redemption condition).<sup>49</sup>

One example of an area that the Committee should address with guidance is the interaction of the limited redemption condition and calculation of a fund's reasonably anticipated trade size ("RATS") for purposes of Rule 22e-4. Under Rule 22e-4, RICs must calculate their RATS when classifying their investments into the four liquidity buckets.<sup>50</sup> However, as previously discussed, an acquiring fund may have difficulty determining the number of acquired fund shares outstanding, as the acquiring fund may not have full transparency into the number of shares of an acquired fund outstanding on any given day. Determining fund shares outstanding is especially challenging in unaffiliated fund of funds arrangements. Requiring an acquiring fund to determine the number of shares outstanding of an acquired fund would impose an additional administrative burden and costs on acquiring funds because RICs calculate RATS based on a *dollar* amount (as opposed to the number of shares of a security they hold). The limited redemption condition would impose an extra layer of complexity in terms of converting a fund's RATS dollar amount to a percentage ownership of an acquired fund and would cause an additional burden in terms of tracking the number of shares outstanding of an acquired fund.

The Committee suggests that the Commission remove, in the final rule, language that would require a RIC to consider the limited redemption condition when complying with Rule 22e-4 and, if the Commission retains any such references, that the Commission provide further guidance in the adopting release.

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<sup>49</sup> Larger fund groups will be required to comply with the classification requirements of Rule 22e-4 as of June 2019, while smaller fund groups must come into compliance by December 2019. Under normal circumstances, investments in acquired funds would be classified as "liquid" for purposes of Rule 22e-4; however, as discussed, the guidance in the Proposed Rule could affect the reasonably anticipated trade size calculation.

<sup>50</sup> If the fund or its adviser has information about any market, trading, or investment-specific considerations that are reasonably expected to significantly affect the liquidity characteristics of the investment as compared with other fund holdings in that asset class, the fund is required to separately classify that investment. To this end, a fund must determine whether trading different portions of a position in a particular investment or asset class, in sizes that the fund would reasonably anticipate trading, is reasonably expected to significantly affect the liquidity of the investment. If so, the fund must consider that determination when classifying the liquidity of the investment or asset class.

**(ii) Fees and Other Considerations**

**(1) Best Interest Determination**

Proposed Rule 12d1-4(b)(3)(i) requires an acquiring fund's investment adviser to determine whether such fund's investment in an acquired fund is in the best interest of the acquiring fund, based upon the adviser's evaluation of: "(i) the complexity of the fund of funds structure, and (ii) the aggregate fees associated with the fund's investment in an acquired fund," before causing the fund to invest in an acquired fund in reliance on the Proposed Rule.<sup>51</sup> The determination, and the related rationale, are required to be presented to the acquiring fund's board before the fund invests in an acquired fund.<sup>52</sup> The Commission notes that the required evaluations are intended "both to help guard against the construction of a complex structure that could be confusing to the acquiring fund's shareholders and to help prevent excessive layering of fund costs."<sup>53</sup>

The Commission has requested comment on whether the best interest determination should be included in the final rule.<sup>54</sup> The Committee questions the need for this requirement, since a fund's adviser implicitly makes a best interest determination when selecting any investment for a fund. The Commission has repeatedly stated its view, including in the Proposing Release, that an investment adviser has a fiduciary duty to its client, citing the U.S. Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963).<sup>55</sup> The Committee believes, in light of this long-established principle, that it is unnecessary for a fund of funds exemptive rule to contain a best interest determination requirement. On the other hand, the Committee believes that it is appropriate for the Commission to highlight areas (such as whether an investment would give rise to duplicative or excessive fees) that it believes an investment adviser should consider before causing an acquiring fund to invest in an acquired fund.

The Committee suggests that the Commission consider, as an alternative to a best interest determination, guidance setting out the specific factors the Commission believes should be among those considered before an adviser causes a fund to make such investments. This guidance could be updated from time to time to reflect changes in the market. Such an approach would avoid codifying specific factors in a rule that may remain in place for many years. The Committee believes that a reasonable adviser would already take into account the factors set out in the Proposing Release.

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<sup>51</sup> Proposing Release at 60.

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> *Id.* at 72.

<sup>55</sup> *See, e.g., id.* at 41.

The Committee believes that the Commission could also issue guidance in the adopting release suggesting that a board may wish to receive, from time to time, a report from a fund's adviser on the fund's investment in other funds, as well as the rationale for such investment. The Committee believes that it would be preferable for the guidance to allow a board to determine whether it would find such a report helpful in fulfilling its general oversight responsibilities, as well as the frequency with which it receives such a report, rather than mandating that the board receive and review such a report in connection with initial investments and at least annually thereafter.

As noted above, the Committee recommends that the best interest determination not be a part of the final rule. If the Commission determines to retain this requirement, the Committee recommends that submission of the determination and its rationale to the fund board not be a condition to a fund making an investment in another fund. Instead, the Committee suggests that the determination be presented to the acquiring fund's board at its next regularly scheduled meeting. This would prevent the strictures of the rule from potentially causing harm to investors by delaying (potentially for months) an investment that the fund's adviser has determined to be in the best interest of the fund. If the Commission does not accept either of these approaches, the Committee requests clarification on whether the best interest determination, if an element of a final rule, would be required in advance of all investments in acquired funds, or each investment in a new acquired fund, in reliance on the rule. Proposed Rule 12d1-4(b)(3)(i) states that the acquiring fund's adviser must make such a determination "before investing in an acquired fund in reliance on [the Proposed Rule]." The Proposing Release states that "[t]he [Proposed Rule] would require the adviser to make this determination before investing in acquired funds in reliance on the rule."<sup>56</sup> The Commission notes, however, in the Proposing Release that an adviser to an acquiring fund "could consider establishing parameters for routine investments in acquired funds, and review individual transactions that are outside of those parameters."<sup>57</sup> It is not clear from these statements, whether an acquiring fund's adviser would need to make a best interest determination in advance of each investment in an acquired fund (or for each acquired fund), including investments within routine parameters established by the adviser. As noted above, the Committee urges the Commission to eliminate the best interest determination requirement, but we request to the extent that the requirement remains in place in a final rule that the Commission clarify whether such determination must be made with respect to all investments in acquired funds and whether advisers may effectively pre-approve certain routine investments in acquired funds by establishing parameters for such investments. We note that the latter approach is consistent with advisers' fiduciary duties to their clients and that this approach could reduce the volume of adviser reports to boards.

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<sup>56</sup> *Id.* at 60.

<sup>57</sup> *Id.* at 62.

## **(2) Board Reporting Implications of the Best Interest Determination**

Proposed Rule 12d1-4(b)(3) requires an adviser to present its best interest determination, as well as the rationale underlying it, to the acquiring fund's board of directors before investing in an acquired fund in reliance on the Proposed Rule, and on at least an annual basis thereafter. The Commission has requested comment on whether this determination should be required and, if so, whether the frequency of determinations should be prescribed.<sup>58</sup> In response to these questions, as noted above, the Committee urges the Commission to eliminate from the final rule both the best interest determination, and the presentation of it to a fund's board prior to making an investment in an acquired fund. Assuming that the Commission decides to retain the required determination and presentation to the fund board, the Committee has two concerns about the proposed requirement that each such determination be presented to the fund board before the fund may invest in an acquired fund in reliance on the Proposed Rule. First, given the realities of the scheduling of fund board meetings, which are often quarterly, this requirement may result in unnecessary delays in a fund's investments in other funds. Second, the Committee is concerned that such a requirement could result in burdening fund directors with a new category of compliance-type report that we believe is not only unnecessary, but also inconsistent with the Commission's view of the proper role of fund boards under the 1940 Act.

The Commission's position as to the role of boards in fund compliance matters is reflected in Rule 38a-1 under the 1940 Act, which requires funds to adopt compliance programs and to appoint a chief compliance officer ("CCO") to administer such programs. Embodied in Rule 38a-1 is the Commission's view that the board's proper role with respect to compliance matters is oversight rather than day-to-day administration. The Commission noted, in adopting Rule 38a-1, that "providing fund boards with direct access to a single person with overall compliance responsibility for the fund" would "enhance the efficiency of funds' ... operations by centralizing responsibility for the compliance function" under the CCO.<sup>59</sup> The rule clearly contemplates that boards would exercise oversight of the compliance program without "becom[ing] involved in the day-to-day administration of the program."<sup>60</sup>

The Commission's position as to the role of fund directors in connection with 1940 Act compliance has been repeatedly affirmed by the Commission's Division of Investment Management (the "Division"). In a 2018 no-action letter, for example, the Division did not recommend enforcement action against fund directors who sought to rely on CCO reports concluding that transactions effected in reliance on certain exemptive rules were compliant with board procedures adopted pursuant to the relevant exemptive rule, rather than the board itself making such a determination.<sup>61</sup>

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<sup>58</sup> *Id.* at 72.

<sup>59</sup> *Compliance Programs of Investment Companies and Investment Advisers*, Investment Company Act Release No. 26299 (Dec. 17, 2003), at text accompanying n. 42.

<sup>60</sup> *Id.*

<sup>61</sup> See *Independent Directors Council*, SEC No-Action Letter (Oct. 12, 2018).

The Committee believes that the CCO's role under Rule 38a-1 obviates the need for advisers to report to fund directors on all proposed investments in reliance on the Proposed Rule. As noted above, we are of the view that one possible alternative to a report would be for the Commission to issue guidance in the adopting release suggesting that the acquiring fund's board consider whether it would find such a report helpful in fulfilling its general oversight responsibilities, as well as the frequency with which it wishes to receive such a report.

## **2. Rescission of Rule 12d1-2**

The Commission proposes to rescind Rule 12d1-2 in seeking to create a more consistent and efficient framework for regulating fund of funds arrangements and thereby harmonize the overall regulatory structure.<sup>62</sup> Rule 12d1-2 permits a fund relying on Section 12(d)(1)(G) of the 1940 Act (for purposes of acquiring the shares of affiliated open-end funds) to also acquire the securities of other, non-affiliated open-end funds (subject to the limits in Section 12(d)(1)(A) or 12(d)(1)(F)); to invest directly in stocks, bonds, and other securities; and to acquire the securities of money market funds in reliance on Rule 12d1-1.<sup>63</sup> Rule 12d1-2 was designed to provide an acquiring fund relying on Section 12(d)(1)(G) with greater flexibility to meet its investment objective by complementing an acquiring fund's investments in affiliated funds.<sup>64</sup> Rescission of Rule 12d1-2 would eliminate the flexibility that the Commission intended fund of funds relying on Section 12(d)(1)(G) to have. The Commission has requested comment on, among other things, whether Rule 12d1-2 should be rescinded and whether such rescission would affect funds that currently rely on Section 12(d)(1)(G).<sup>65</sup>

Investors have come to rely on a category of mutual funds adopting fund of funds structures to allocate fund assets across a wide-range of asset and security types, investment techniques, and market exposures. In the experience of the Committee's members, these fund of funds pursue their investment objectives in their investors' interests by relying on Rule 12d1-2 to efficiently allocate assets across often specialized asset and investment types, including affiliated and non-affiliated traditional mutual funds, ETFs, and direct investment in non-fund securities, serving their investors' needs by providing them with, among other things, target date retirement

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<sup>62</sup> Proposing Release at 87-89.

<sup>63</sup> *Id.* at 87.

<sup>64</sup> See, e.g., Wells Fargo Asset Allocation Fund, prospectus dated Sept. 1, 2018 (inception 1996) (Fund of funds investing in affiliated funds or directly in securities and incorporating a Tactical Asset Allocation (TAA) Overlay strategy to invest in exchange-traded futures contracts across a variety of asset classes including stocks, bonds, and currencies); PIMCO Global Multi-Asset Fund, prospectus dated Jul. 30, 2018 (as supplemented Feb. 28, 2019) (inception 2008) (Fund intended for investors who desire asset allocation decisions made by a professional investment manager). Adviser uses varying combinations of acquired funds (which include affiliated and unaffiliated funds and/or direct investments in fixed income instruments, equity securities, forwards and derivatives).

<sup>65</sup> Proposing Release at 92.

strategies,<sup>66</sup> one-stop asset allocation,<sup>67</sup> current yield with a focus on seeking to protect investor purchasing power through capital appreciation,<sup>68</sup> and a tool designed to complement and diversify traditional stock and bond portfolios.<sup>69</sup> Rescission of Rule 12d1-2, if undertaken along with Proposed Rule 12d1-4, would disrupt the investor marketplace and potentially remove from investors' menu of investment options a significant number of fund offerings from this category of funds.

If Rule 12d1-2 is rescinded, many funds that currently rely on Section 12(d)(1)(G) to execute their investment strategies would have to choose between (i) operating in reliance on Proposed Rule 12d1-4 (as discussed above), which allows an acquiring fund to invest up to 25% in both affiliated and non-affiliated funds and also invest in the kinds of non-fund securities currently allowed by Rule 12d1-2, but would impose the limited redemption condition that is, at best, limiting of an acquiring fund's flexibility and, at worst, inconsistent with the fund's achieving its investment goals,<sup>70</sup> or (ii) continue to operate in reliance on current Section 12(d)(1)(G), which allows an acquiring fund to invest in an affiliated fund without limit and invest in non-affiliated funds up to the limits prescribed by 12(d)(1)(A), but would remove the flexibility to use non-fund securities currently provided by Rule 12d1-2. In this regard, rescission of Rule 12d1-2 seems to pursue regulatory consistency and efficiency with an eye on "harmony," but at the expense of potentially diminishing investment options in the marketplace, as evidenced by the Commission's implicit acknowledgement that rescission of the rule could pose a "hardship" on existing fund arrangements.<sup>71</sup>

The Committee encourages the Commission to consider the adverse consequences of rescission of Rule 12d1-2 if rescission is effectuated along with the adoption of Proposed Rule 12d1-4. Specifically, the Committee believes that the Commission should factor in the adverse effects on the many fund of funds arrangements that may need to restructure, or worse, liquidate after their sponsors conclude that no viable alternative product offering would make sense. Both scenarios threaten removal from investors of important options for accessing exposure to certain assets, investment techniques, and markets.

As proposed above, one alternative the Commission should consider is to eliminate Proposed Rule 12d1-4's limited redemption condition entirely or otherwise substantially restructure it. Such an approach would address the inflexibility imposed by the limited redemption

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<sup>66</sup> PIMCO REALPATH® Blend 2050 Fund, prospectus dated Oct. 31, 2018 (as supplemented Apr. 1, 2019) (inception 2014).

<sup>67</sup> PIMCO Global Multi-Asset Fund, n. 62.

<sup>68</sup> AC Alternatives Income Fund, prospectus dated Mar. 1, 2019 (inception 2015).

<sup>69</sup> Dreyfus Alternative Diversifier Strategies Fund, prospectus dated Mar. 1, 2019 (inception 2014).

<sup>70</sup> See *supra* Section 1.b.(i)(1).

<sup>71</sup> Proposing Release at 91. Acknowledging the hardship produced by rescission of the rule, the Commission indicated that "funds relying on current rule 12d1-2 [would have to] bring their future operations into conformity with Section 12(d)(G)(1) or proposed rule 12d1-4."



condition and concurrently allow for a wider and deeper breadth of underlying acquired funds and non-fund investment options an acquiring fund can use to achieve its investment objective. This approach would also achieve the Commission's goal of regulatory harmony.

The Commission should, in the alternative, consider retaining Rule 12d1-2, which would maintain the flexibility on which fund of funds and their investors have come to rely. We acknowledge that this alternative may not be entirely consistent with the Commission's overall goal of regulatory harmony, but it would allow the many fund of funds that already operate in reliance on the existing Section 12(d)(1)(G) framework to continue to operate with predictability and without disruption to those funds and their shareholders.<sup>72</sup>

### **3. Rescission of Exemptive Orders — Withdrawal of Staff Letters**

#### **a. Rescission of Exemptive Orders Permitting Fund of Funds Arrangements**

The Committee strongly believes that the Commission should clarify that the Commission intends to rescind only the orders described in the Proposing Release. In the Proposing Release, the Commission has proposed to rescind all orders granting relief from Sections 12(d)(1)(A), (B), (C), and (G) (collectively, "Fund of Funds Orders") with one specified exception for orders that permit certain interfund lending arrangements.<sup>73</sup> The Committee believes that other existing exemptive orders should continue to be effective. The Committee notes, for example, that the Commission has granted exemptive relief from Sections 12(d)(1)(A) and (B) to allow funds to invest cash collateral in other funds in the context of securities lending programs.<sup>74</sup> The Commission also has granted exemptive relief from Sections 12(d)(1)(A) and (B) to permit funds to sweep uninvested cash into other funds as part of a cash management program.<sup>75</sup> These types of orders do not relate to the fund of funds arrangements described in the Proposal and the holders of these orders may not recognize that their exemptive orders would be rescinded by an adopted rule, if that is the Commission's intention.

In the past, the Commission has taken different approaches in codifying prior exemptive orders, which raises several important questions with respect to the Proposal's rescission of prior Fund of Funds Orders. In 1983, the Commission adopted Rule 2a-7 under the 1940 Act governing

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<sup>72</sup> Notwithstanding the Commission's overall goal, a Section 12(d)(1)(G) regime would continue to exist as an option for certain fund of funds that have come to rely on the flexibility that the combination of Section 12(d)(1)(G) and Rule 12d1-2 provide.

<sup>73</sup> Proposing Release at 95-96.

<sup>74</sup> See, e.g., *Dresdner Bank AG*, Investment Company Act Release Nos. 26073 (Jun. 11, 2003) (notice) and 26096 (Jul. 9, 2003) (order).

<sup>75</sup> See, e.g., *Diamond Hill Funds*, Investment Company Act Release Nos. 26058 (May 28, 2003) (notice) and 26079 (Jun. 24, 2003) (order).

money market funds.<sup>76</sup> In adopting Rule 2a-7, the Commission codified portions of prior exemptive relief orders but did not rescind these prior orders, notwithstanding that Rule 2a-7 was “designed to obviate the need for individual money market funds to file applications for exemptive orders to permit the use of either penny-rounding or amortized cost methods.”<sup>77</sup> Instead, the Commission gave funds the option to rely on Rule 2a-7 or continue to rely on their individual exemptive orders.<sup>78</sup> The Committee notes that, when the Commission adopted Rule 12d1-1 under the 1940 Act in 2006, the Commission did not rescind any orders previously issued under Sections 12(d)(1)(A) and (B). It is unclear whether the exemptive orders that the Commission previously determined not to rescind would now be rescinded in connection with the adoption of the Proposal. If that is not the Commission’s intention, then it should clarify that such orders are not subject to rescission.

In 1989, the Commission adopted Rule 11a-3 under the 1940 Act, which “permits a mutual fund or its principal underwriter to make certain exchange offers to the fund’s shareholders or to shareholders of another fund in the same group of funds.”<sup>79</sup> The Committee notes that, when the Commission proposed Rule 11a-3, the Commission stated that it would issue a notice to each registered fund that received an exemptive order under Section 11(a) of the 1940 Act permitting it to impose an administrative fee on exchange transactions (“Section 11(a) Exemptive Orders”).<sup>80</sup> The Commission stated that the purpose of the notice was to inform the registered fund of the Commission’s intention to amend its exemptive order to comply with Rule 11a-3 when adopted.<sup>81</sup> In accordance with the Rule 11a-3 proposing release, the Commission issued notice to the holders of 50 Section 11(a) Exemptive Orders.<sup>82</sup> Thereafter, under a revised proposal, the Commission clarified that Rule 11a-3 would supersede all prior Commission orders and that recipients of such orders could rely on the comment process if so desired.<sup>83</sup> In the Rule 11a-3 adopting release, the Commission confirmed that the holders of Section 11(a) Exemptive Orders had reasonable notice

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<sup>76</sup> *Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies*, Investment Company Act Release No. 13380 (Jul. 18, 1983).

<sup>77</sup> *Id.* at 2.

<sup>78</sup> *Id.* The adopting release stated that: “the Commission recognizes that money market funds with existing exemptive orders may wish to rely on the rule rather than their individual orders. The Commission has no objection to money market funds ceasing to rely on their individual exemptive orders and using instead rule 2a-7 as the basis for their pricing or valuation method provided that the board of directors of any such money market fund approves the change and the fund makes any necessary disclosure to shareholders.”

<sup>79</sup> *Offers of Exchange Involving Registered Open-End Investment Companies*, Investment Company Act Release No. 17097 (Aug. 24, 1989) at 1 (“Rule 11a-3 Adopting Release”).

<sup>80</sup> *Offers of Exchange Involving Open-End Investment Companies and Unit Investment Trusts*, Investment Company Act Release No. 15494 (Dec. 23, 1986) at 1.

<sup>81</sup> *Id.*

<sup>82</sup> *See Notice Under the Investment Company Act of 1940 Proposing to Amend Prior Commission Orders; American Pioneer Government Securities Fund, Inc., et al.*, Investment Company Act Release No. 15546 (Jan. 29, 1987).

<sup>83</sup> *Offers of Exchange Involving Registered Open-End Investment Companies and Unit Investment Trusts*, Investment Company Act Release No. 16504 (Jul. 29, 1988) at 2 (“Revised Proposing Release”).

of its intent to rescind their orders.<sup>84</sup> Specifically, the Commission noted that publication in the *Federal Register* satisfied the Commission's obligation to notify all interested persons, but that, in addition, the Division had sent to all holders of prior orders individual letters to remind them of their opportunity to participate in the comment process.<sup>85</sup>

The steps taken by the Commission to rescind the Fund of Funds Orders are not consistent with its prior approaches, including when the Commission rescinded the Section 11(a) Exemptive Orders. If the Commission does intend to rescind exemptive orders similar to the ones identified above that are outside the scope of traditional fund of funds arrangements, the Committee believes that the Commission has not given the holders of such exemptive orders appropriate notice, as many holders of these exemptive orders may be unaware that the exemptive orders under which they are currently operating are in jeopardy. Because the holders of these exemptive orders have not received appropriate notice, they may be unable to properly avail themselves of the opportunity to provide comments. For that reason, the Committee recommends that the Commission provide more specific notice to holders of the exemptive orders that it intends to rescind.

The Proposal indicates that the Commission expects "to rescind the exemptive orders providing relief from Sections 12(d)(1)(A) and (B) that has been included in our ETF and ETMF orders."<sup>86</sup> This approach indicates that the Commission may rescind only portions of orders.<sup>87</sup> Like ETF and ETMF orders, some other orders contain relief from other provisions in addition to Section 12(d)(1). In light of the existence of such orders, the Committee would recommend that the Commission clarify whether it is rescinding the full orders or merely those parts of the orders relating to Sections 12(d)(1)(A) and (B). Again, if the Commission is intending to rescind the full orders, including relief unrelated to Section 12(d)(1), this may come as a surprise to the recipients of such orders. Without clarification prior to the adoption of Proposed Rule 12d1-4, the recipients of these orders will not have the opportunity to comment and, therefore, no recourse following the adoption of the Proposed Rule.

The Committee is concerned not only by the procedural matters described above, but also more generally with the undue hardship that would result to those entities relying on exemptive

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<sup>84</sup> See Rule 11a-3 Adopting Release at 5.

<sup>85</sup> *Id.* at n. 17 (citing Revised Proposing Release at n. 12-14 and accompanying text). The Commission also noted that holders of the prior orders received public notice in the revised rule proposal that Rule 11a-3 would supersede all such orders and that such holders would be able to participate in the comment process. *Id.* at 5.

<sup>86</sup> Proposing Release at 96.

<sup>87</sup> See *Exchange-Traded Funds*, Investment Company Act Release No. 33140 (Jun. 28, 2018) at 143-144. On June 28, 2018, the Commission proposed Rule 6c-11 under the 1940 Act, which would allow eligible ETFs that satisfy certain conditions to operate without obtaining exemptive relief and replace existing exemptive orders currently governing ETFs. The proposed rescission of exemptive orders in that case would be "limited to the portions of an ETF's exemptive order that grant relief related to the formation and operation of an ETF and, with the exception of certain master-feeder relief [ . . . ], would not rescind the relief from section 12(d)(1) and sections 17(a)(1) and (a)(2) under the Act related to fund of funds arrangements involving ETFs." In short, the Commission proposed to amend in prior orders the formation of ETF provisions and leave the provisions relating to Sections 12(d)(1), 17(a)(1), and 17(a)(2) intact, thereby bifurcating the orders.

orders that fall outside the obvious scope of Proposed Rule 12d1-4. The Committee believes that rescinding all exemptive orders other than those pertaining to interfund lending arrangements as proposed by the Commission would disrupt long standing business practices based on exemptive orders received years ago. Companies that have received past exemptive relief would be left with no alternative other than to change their operations, despite the potentially significant amounts of resources spent to seek exemptive relief and establish operations in reliance on that relief. Moreover, the withdrawal of such orders could have the unintended consequence of causing investor harm. Those companies adversely affected may be forced to close operations, thereby limiting shareholders' investment options and access to diversified products. To the extent the Commission does rescind certain exemptive orders that are not covered by Proposed Rule 12d1-4, the Committee recommends that, if and when Proposed Rule 12d1-4 is adopted, the holders of such exemptive orders be afforded at least a one-year period to transition operations or to obtain a new order based on individual circumstances.

**b. Withdrawal of Staff No-Action and Interpretive Letters Relating to Section 12(d)(1)**

The Proposal states that “the staff of the Division of Investment Management is reviewing staff no-action and interpretive letters relating to Section 12(d)(1) to determine whether any such letters should be withdrawn in connection with” the adoption of Proposed Rule 12d1-4.<sup>88</sup> The Commission has also said that “to the extent that there are concerns with the withdrawal of any of the letters, commenters should provide comments.”<sup>89</sup> The Commission has not, however, provided any guidance regarding which letters could potentially be withdrawn.

The Committee finds it troubling that the Commission staff may determine to withdraw certain letters without providing any specificity beforehand as to which letters. Both holders of such letters and other funds that rely on such letters should be provided a meaningful opportunity to comment. The only indication in the Proposing Release as to the letters that may be rescinded appears in the economic analysis section of the Proposal, where the Commission generally references that letters have permitted certain industry practices to develop, including (i) the creation by some funds of three-tier master-feeder structures for tax management, cash management, or portfolio management purposes; (ii) the investment by other funds that have otherwise complied with the restrictions in Rule 12d1-2 in assets that may not be securities; (iii) the depositing by sponsors of unit investment trusts (“UIT”) of units of existing trusts into portfolios of future UIT series; (iv) the investment by foreign pension funds and profit sharing funds, and foreign subsidiaries and feeder funds in other funds beyond the limits of Section 12(d)(1); and (v) the investment of foreign funds in other funds under Section 12(d)(1) to the same extent as private funds.<sup>90</sup> The Committee believes that, rather than effectively requiring funds to surmise which letters might be referenced by the Proposing Release, and whether the only letters

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<sup>88</sup> Proposing Release at 98.

<sup>89</sup> *Id.*

<sup>90</sup> *Id.* at 116.

that might be withdrawn are those relating to these practices, the Commission or the Division should provide more specific notice of the letters to be withdrawn.

The Committee recommends, with respect to certain no-action letters that may be under consideration for withdrawal, that the Commission either not withdraw these letters or take appropriate steps to incorporate the relief described in the no-action letters into the final rule when adopted. The Committee notes in particular that, through Commission staff no-action letters, the Commission staff has stated that it would not recommend that the Commission take any enforcement action under Sections 12(d)(1)(A) and (B) (and other sections of the 1940 Act) if an acquiring fund relying on Section 12(d)(1)(G) purchases or acquires shares of an underlying fund that then purchases or acquires shares of a central fund subject to certain conditions.<sup>91</sup> This so-called three-tier structure appears to be prohibited under the scope of Proposed Rule 12d1-4. The Commission staff has similarly provided no-action relief under Section 12(d)(1) for foreign feeder funds that acquire securities of open-end investment companies in excess of the limits of Sections 12(d)(1)(A) and (B) subject to certain conditions.<sup>92</sup> Again, it appears from the Proposal that unregistered investment companies, such as foreign funds, are specifically excluded from the scope of Proposed Rule 12d1-4. These no-action letters were issued within the last two to three years and, as far as we are aware, no issues have arisen under such letters that would implicate public policy concerns under Section 12(d)(1). The Committee believes that the relief granted under these no-action letters is not contradictory to Proposed Rule 12d1-4 and still satisfies the Section 12(d) policy concerns laid out in each of the letters. For that reason the Committee recommends that these no-action letters remain in force or that the Commission incorporate the relief granted under such letters in the final rule as adopted.

The Committee has concerns more generally as to why the Commission or Commission staff would consider withdrawing no-action letters of the types described above that have been operating for years, particularly as neither the Commission nor Commission staff has raised any regulatory or other concerns. Like the Commission's proposal to rescind certain exemptive orders, the withdrawal of such letters will disrupt long standing business practices that have been in existence for years and potentially limit shareholders' investment options and access to diversified products. Companies operating in accordance with the letters would appear to have no recourse other than to change their operations, despite the resources spent to seek relief as well as to establish operations consistent with the relief granted. Furthermore, unlike the proposal to rescind the Fund of Funds Orders, which are specific to each applicant, it is unknown how many other funds are relying on the no-action relief previously granted. Thus, the potential effect of rescinding the letters could be much more significant. The Committee recommends that, to the extent a no-action letter is withdrawn that is not covered by Proposed Rule 12d1-4, any person relying on such relief be afforded at least a one-year period to transition operations or seek additional relief.

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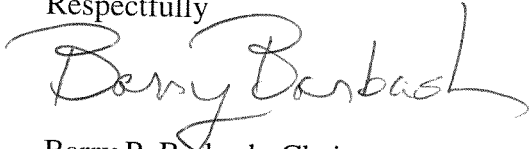
<sup>91</sup> See *Franklin Templeton Investments*, SEC No-Action Letter (Apr. 3, 2015); *Thrivent Financial for Lutherans and Thrivent Asset Management, LLC*, SEC No-Action Letter (Sept. 27, 2016).

<sup>92</sup> See 2017 Dechert Letter; see also 2009 Dechert Letter.

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The Committee appreciates the opportunity to comment on the Proposing Release. If we can be of any further assistance in this regard, please call me at (212) 728-8293.

Respectfully

A handwritten signature in cursive script that reads "Barry Barbash". The signature is written in dark ink and is positioned below the word "Respectfully".

Barry P. Barbash, Chair  
Committee on Investment Management Regulation

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