Statement at Open Meeting on Proposed Rule 12d1-4 under the Investment Company Act of 1940 Governing Fund of Funds Arrangements

Commissioner Kara M. Stein

Dec. 19, 2018

June 28, 2018I would like to join the Chairman in thanking the staff for their hard work on this proposed rule[1] and for answering all of my many questions. In particular, I would like to thank Joel Cavanaugh, John Foley, Jacob Krawitz, Melissa Gainor, Brian Johnson, and Sarah ten Siethoff.

Funds investing in other funds has been the subject of debate since the 1920s.[2] At the beginning of the 20th century, state general incorporation laws expressly permitted corporations to own the securities of other corporations, largely without limitation.[3] Because investment companies were entities principally arising out of state law, several investment companies had significant investments in other investment companies.

Many of these arrangements, however, caused harm to investors in the 1920s and 1930s. The problems were significant. They included undue investment influence on the underlying fund, self-dealing, outsized complexity, fee layering or duplication, and unwarranted or undisclosed delegation of fund management.[4] In fact, the Commission itself noted that "pyramiding of investment companies intensifie[d] management problems as well as increase[d] the cost of management."[5] For example, in a study of fund of funds arrangements during that time period, the Commission recounted examples where "tiers of investment companies under common control ha[d] been constructed purely as a means of deriving personal profits for the controlling individuals."[6] Congress responded by including section 12(d)(1) in the Investment Company Act of 1940.[7]

At its core, section 12(d)(1) places bright-line limits on how much a fund can invest in another fund.[8] While the provisions governing fund of funds arrangements have been changed over time, they generally have helped prevent many of the abuses that occurred almost a century ago.

Today, there are over 4,000 funds of funds with total gross assets of more than $5.7 billion.[9] Examples of fund of fund arrangements that have developed over the last century include target allocation (or target date) funds.[10] We call them "lifecycle funds" in the federal government's thrift savings plan.[11] Often, these allocation funds get exposure to multiple asset classes by investing in other funds. Instead of conducting voluminous individual securities transactions, the allocation funds are able to re-allocate exposure to asset classes relatively quickly by increasing or decreasing exposure to underlying funds.

There are many other uses of fund of funds arrangements, including equitizing cash, hedging, and risk-management. Certain of these arrangements could not exist without exemptions from the bright-line ownership limits in sections 12(d)(1)(A) and (B)—either by statutory exemption, exemptive rule, or Commission-granted order. Like other areas of investment company regulation,[12] there is now a patchwork quilt of exemptive relief,

rules, and guidance. Each patch on the quilt represents different circumstances, conditions, representations, and rules.

Today's proposal seeks to consolidate existing rules and individual Commission exemptions. The proposed rule would clean up a lot of the unique and bespoke patches of that quilt, help level the playing field, and help clarify for investors, regulators, and other funds which set of conditions a fund should or is relying upon.

However, it is tremendously important that we get this rule right. We must tailor the rule's conditions so that it, along with the overall fund of funds regulatory architecture, continues to protect investors. We simply cannot afford to let the problems of the past re-emerge.[13] As such, I would like to briefly highlight a few concerns of my own regarding the rule's scope and conditions in hopes of garnering robust public comment on this complex area of law.

First, the proposed rule broadens the scope of exemptive relief to areas in which the Commission has either received little exemptive application interest or not permitted.[14] One rationale mentioned in the release for expanding the exemptive relief is that it would "eliminate unnecessary and potentially confusing distinctions."[15] I recognize that it can make sense to avoid regulatory distinction without a difference. But are we casting the net too wide by including certain types of pooled vehicles in the proposed rule? For example, are there investor protection concerns with including closed-end underlying funds that are not listed on a national securities exchange? Have we proposed appropriate conditions that work well across several types of arrangements? I hope commenters provide their best thoughts on these details.

Second, the proposed rule includes a condition that limits a fund that owns more than 3% of the outstanding shares of an underlying fund from redeeming more than 3% of that underlying fund within a 30-day period.[16] This condition is intended to protect against undue influence. It is designed to stop the top-level fund from threatening to redeem a large chunk of shares if the underlying fund does not comply with the top level fund's demands. A condition that limits undue influence through large-scale redemptions by the top-level fund is certainly helpful. However, several funds in a single fund complex may own shares of the same underlying fund. As such, I would have liked to see a condition that limits redemptions of more than 3%, in the aggregate, in a 30-day period by all funds in the same complex, where the funds collectively own more than 3% of an underlying fund's outstanding shares.[17]

Third, the release asks several questions about certain fees and expenses associated with fund of funds arrangements.[18] These fees are called "acquired fund fees and expenses"—or AFFEs. Investors care about all of the fees they pay—whether the fees are paid directly to the top-level fund or indirectly to the underlying fund. I believe we should be cautious about scaling back fee disclosure or any rollback on transparency. The presentation of fees should be fair, accurate, and comparable but it should also fully inform investors about the fees they are actually paying. I would encourage the public—and in particular, investors—to look closely at this line of questioning.

The last point I would like to draw commenters' attention to is the complexity that fund of funds arrangements can create. Are investors fully aware of the circumstances and risks of their fund's exposure to other funds?[19] While the securities laws require disclosure about a fund's investments, should we take additional steps to encourage greater consistency in fund of funds disclosure and better descriptions regarding the risks and expenses involved with such an arrangement?

The proposing release includes these and other important questions. As a result, I am happy to support this proposed rule governing fund of funds arrangements and I hope that commenters take some time to weigh in on these important issues.

Thank you.

[1] Fund of Funds Arrangements (hereinafter "Proposing Release").

[2] Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, Pursuant to Section 30 of the Public Utility Holding Company Act of 1935, pt. 3, ch. 7, Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies, H.R. Doc. No. 136, 77th Cong., 1st Sess., 2721-95 (1941) ("Investment Trust Study").

[3] *Id.* at 2721 n.1.

[4] *Id.*at 2721-95.

[5] *Id.* at 2731.
[6] *Id.*
[7] The current form of section 12(d)(1) can be found at 15 U.S.C. 80a-12(d)(1).
[8] *See* 15 U.S.C. 80a-12(d)(1)(A)-(B).
[9] *See* Proposing Release at Section IV.B. Note that these figures, which are from the proposed rule's economic analysis, do not include funds that invest in money market funds as their only investment in other funds and also do not include master-feeder structures. *Id.*
[10] Not all allocation funds use fund of funds structures.
[11] *Lifecycle Funds*, Thrift Savings Plan, https://www.tsp.gov/InvestmentFunds/FundOptions/index.html(last visited Dec. 14, 2018).
[12] *See* Commissioner Kara M. Stein,*Statement at Open Meeting on the Proposed Rule 6c-11 under the Investment Company Act of 1940 Governing Exchange-Traded Funds* (June 28, 2018), *available at* https://www.sec.gov/news/public-statement/statement-stein-exchange-traded-funds-062818; *see also* Commissioner Kara M. Stein, *Statement on Use of Derivatives by Registered Investment Companies and Business Development Companies*(Dec. 11, 2015), *available at*https://www.sec.gov/news/statement/stein-statement-on-use-of-derivatives.html.
[13] *See supra*note 4 and accompanying text.
[14] *See generally* Proposing Release at Section II.A.
[15] *See id.*
[16] *See generally id.*at Section II.C.2.
[17] I am also interested to hear commenters' thoughts on how to allocate the 3% redemptions in a 30-day period across funds in the same complex.
[18] *See id.*
[19] A related issue is whether disclosure of "target date" funds, which often are structured as fund of funds arrangements, is sufficient for investors to understand their risks and fees. *See Recommendation of the Investor Advisory Committee, Target Date Mutual Funds* (Adopted Apr. 11, 2013),*available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac-recommendation-target-date-fund.pdf; *see also Proposed Rule on Investment Company Advertising: Target Date Retirement Fund Names and Marketing,* Investment Company Act Release No. 31004 (Apr. 3, 2014) [79 FR 19564 (Apr. 9, 2014)].