



April 30, 2019

**Via Electronic Submission:** [rule-comments@sec.gov](mailto:rule-comments@sec.gov)

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

**Re: Proposed Rule on Fund of Fund Arrangements; File Number S7-27-18**

Dear Ms. Countryman:

Managed Funds Association (“MFA”)<sup>1</sup> appreciates the opportunity to provide comments in response to the SEC’s proposal on fund of funds arrangements and new rule 12d1-4 under the Investment Company Act of 1940 (the “Investment Company Act”).<sup>2</sup> MFA supports efforts to modernize and simplify the regulatory framework for capital markets and asset managers towards the goals of enhancing investment activity, capital formation and economic growth.

MFA agrees it is an appropriate time to update the regulation of fund of funds arrangements in response to the evolving marketplace and needs of investors. The rule as proposed, however, would unnecessarily exclude private funds from this important modernization effort and thereby create an unlevel playing field for managers of private funds compared to those of registered funds. We urge the SEC to include private funds in the scope of rule 12d1-4 so they may invest in the same manner and subject to the same conditions as registered funds.

We are encouraged by the SEC’s recognition that including private funds in the rule would provide benefits not only to private funds but also to the registered funds in which they could make additional investments. We agree with the statement in the Proposal that “expanding the proposed rule [to include private funds] would increase investment flexibility for those funds, would level the

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<sup>1</sup> The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry’s contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants.

<sup>2</sup> Fund of Funds Arrangements, SEC Release No. IC-33329, 84 F.R. 1286 (Feb. 1, 2019) (the “Proposal”). Among other things, rule 12d1-4 would permit a registered fund to acquire more than 3% of the shares of another registered fund if it complies with certain conditions designed to prevent the types of abuses and concerns that led Congress to enact the limitation in Section 12(d)(1) of the Investment Company Act.

playing field for those funds, and would broaden the funding opportunities for acquired funds because private funds ... could increase their investments in them.”<sup>3</sup>

By including private funds in the rule, the SEC would further its objectives to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. An expanded rule would have clear benefits for investors and capital allocation across U.S. markets and maintain investor protection to the same extent as registered funds. Private funds would comply with the investor protection conditions in a substantially similar manner as registered funds, and the conditions would be equally effective in preventing the abuses they are designed to address. In addition, we believe the extensive regulatory and reporting requirements applicable to SEC-registered private fund managers would provide the SEC with appropriate oversight to ensure compliance with the rule.

If the SEC nevertheless determines to exclude private funds from rule 12d1-4, it should at a minimum allow additional investments by private funds in ETFs subject to appropriate conditions. The SEC has already allowed private funds to invest in certain types of registered funds beyond the limits of Section 12(d)(1) of the Investment Company Act in rule 12d1-1, which provides an exemption for investments in money market funds.<sup>4</sup> The SEC could likewise treat ETFs separately from other registered funds based on their different characteristics, including that they are listed on an exchange and secondary market transactions in ETFs are less likely to raise certain abuses the conditions are designed to prevent.<sup>5</sup> The SEC initially took this approach to address only fund of funds investments in ETFs in March 2008 when it proposed a version of rule 12d1-4 that would have allowed investments in ETFs in excess of the limits of Section 12(d)(1) subject to certain conditions.<sup>6</sup>

### **Including Private Funds in Rule 12d1-4 Would Benefit Investors and Capital Markets**

Including private funds in rule 12d1-4 would benefit both investors and capital markets in light of the substantial growth in the use of ETFs in recent years, which offer an increasingly attractive range of investment opportunities across regions and sectors. With these expanded options, private funds could further incorporate ETFs into a variety of investment strategies for the ultimate benefit of their investors. As ETFs have become more valuable components of investment portfolios of private funds, however, the restrictions in Section 12(d)(1) have become an increasing detriment to funds in their efforts to optimize investment strategies for their investors.

Fund of funds investments can provide a range of benefits to investors and, as the SEC notes in the Proposal, funds invest in other funds for a variety of reasons, including to enhance asset

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<sup>3</sup> 84 F.R. at 1331.

<sup>4</sup> Rule 12d1-1 defines investment company to include a company that would be an investment company under section 3(a) of the Investment Company Act but for the exceptions to that definition provided for in sections 3(c)(1) and 3(c)(7) of the Investment Company Act.

<sup>5</sup> For example, in the Proposal the SEC has indicated that the limitation on redemptions in rule 12d1-4(b)(2) would not apply to sales of shares of ETFs in the secondary market.

<sup>6</sup> See Letter from Richard H. Baker, President and CEO, MFA, to Nancy M. Morris, Secretary, SEC (May 20, 2008), available at: <http://www.managedfunds.org/downloads/MFA%20ETF%20comments%205%2020%2008.pdf> (requesting, among other things, that the rule include private funds).

allocation, achieve diversification, and efficiently gain exposure to a particular market, asset class or region.<sup>7</sup> For example, a fund may be able to more effectively obtain exposure to a foreign market by investing in another fund rather than in individual securities in that country.

Private funds primarily invest in exchange-listed ETFs to achieve these and other objectives, including hedging and risk management of a fund's overall investment portfolio.<sup>8</sup> A manager with a short position in a specific industry or sector may seek to hedge its exposure by acquiring a long position in an industry or sector-specific ETF (and vice versa for a manager with a long position). Private funds also use ETFs to "equitize" cash balances to earn returns higher than money market rates. Additional investments in ETFs would allow private funds, like other institutional investors, greater flexibility to engage in these activities and enhance their ability to meet investment objectives for investors.

As these uses of ETFs continue to expand and offer clear benefits to portfolio management, a rule that would permit registered funds to engage in these types of investments and exclude private funds would impose an increasingly significant advantage to a certain class of institutional investors over others. In effect, the rule would penalize investors in private funds and tilt the playing field in favor of investors in registered funds.<sup>9</sup> The SEC should instead provide private funds with equal flexibility, so their investors may enjoy the same benefits as investors in registered funds.

Including private funds in the rule would also benefit capital markets and price discovery. Prior to the advent of ETFs, it was more common for private funds to hedge industry and sector risk through individual long positions (or short positions) against the dominant issuer in a particular industry or sector. Such a practice is less efficient and could result in a distortion of market prices because issuers were bought and sold as approximate hedges for other positions. In contrast, hedging industry and sector risk through an ETF prevents this type of price distortion and leads to more efficient market prices. The current restrictions in Section 12(d)(1) limit hedging through ETFs and could distort price discovery in this manner.

### **The Conditions in the Rule will Mitigate any Policy Concerns with Fund of Funds Arrangements and Ensure Investor Protection**

The conditions in rule 12d1-4 will be equally effective if applied to private funds in preventing the abuses for which Section 12(d)(1) was enacted. In particular, the conditions will mitigate the policy concerns of undue influence and control of an acquired fund, layering of fees, and the formation of overly complex structures that could confuse investors. We note that the SEC does

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<sup>7</sup> 84 F.R. at 1287.

<sup>8</sup> See Exchange-Traded Funds, SEC Release No. IC-28193, 73 F.R. at 14619 (Mar. 18, 2008) ("ETFs are held today in increasing amounts by institutional investors (including mutual funds) and other investors as part of sophisticated trading and hedging strategies. Shares of ETFs can be bought and held (sometimes as a core component of a portfolio), or they can be traded frequently as part of an active trading strategy").

<sup>9</sup> The SEC states that *for funds within its scope* (emphasis added), "the proposed rule also would level the playing field among these entities, allowing each to invest in the same universe of acquired funds in excess of the limits in section 12(d)(1) . . . We believe that the universe of permissible fund of funds arrangements generally should not turn on the type of the funds in the arrangement." 84 F.R. at 1290.

not identify in the Proposal any other policy concerns unique to private funds that would justify their exclusion from the rule.

It is instructive that rule 12d1-1, which the SEC adopted in 2006, has worked well in providing equivalent treatment for registered funds and private funds to invest beyond the limits of Section 12(d)(1) in money market funds. This approach has provided valuable flexibility to private funds, and we are not aware of any investor protection or other policy concerns regarding private funds since adoption of the rule. While we appreciate that investments in money market funds may raise different investor protection concerns than investments in other types of registered funds, rule 12d1-1 nevertheless provides an important precedent for including private funds in any further relief from Section 12(d)(1). In considering whether to include private funds in rule 12d1-4, we encourage the SEC to assess this prior rulemaking and the benefits that rule 12d1-1 has provided to investors.

In addition to including private funds, we recommend that the SEC amend the rule to provide additional flexibility for private funds to benefit their investors while continuing to protect investors generally.

First, the rule would prohibit an acquiring fund and its advisory group from controlling, individually or in the aggregate, an acquired fund. An advisory group would include an acquiring fund's investment adviser and any person controlling, controlled by, or under common control with the adviser.<sup>10</sup> This aggregation requirement is broader than the existing requirement in Section 12(d)(1)(A) applicable to private funds, which prohibits an acquiring fund and companies it controls from acquiring in the aggregate more than 3% of an acquired fund's shares. We believe the aggregation requirement in Section 12(d)(1)(A) has operated effectively to prevent an acquiring fund from controlling an acquired fund, and we recommend that rule 12d1-4 include the same aggregation requirement.

The proposed aggregation requirement could undermine the overall objective of the rule to permit additional fund of funds investments, such as in the common situation when an investment adviser manages more than one private fund. As proposed, a fund would be limited in its ownership of a registered fund based on a calculation of the total ownership across each fund managed by its investment adviser. In practical terms, therefore, the ownership threshold for such a fund would often be substantially lower than 25%. Depending on the number of funds an investment adviser manages, the ownership limitation for each fund could end up being only slightly higher than the current 3% limit. We recommend that instead, to the extent the SEC is concerned with the potential for evasion of the rule, an effective approach would be to include a provision in the rule prohibiting an entity from doing anything indirectly which, if done directly, would violate the rule.<sup>11</sup>

Second, the rule would require an acquiring fund and its advisory group, if they hold in the aggregate more than 3% of a fund's shares, to either seek voting instructions from its security holders and vote in accordance with their instructions (pass-through voting), or vote the shares in the same

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<sup>10</sup> An advisory group would mean either an acquiring fund's investment adviser or investment sub-adviser or depositor, and any person controlling, controlled by, or under common control with the investment adviser, sub-adviser or depositor. Rule 12d1-4(d).

<sup>11</sup> See e.g., Section 208(d) of the Investment Advisers Act of 1940 (the "Advisers Act"), and Rule 206(4)-5(d) under the Advisers Act.

proportion as the vote of all other holders of the acquired fund (mirror voting). We appreciate the goal of this condition to limit an acquiring fund from influencing the outcome of shareholder votes of an acquired fund. However, we believe the threshold at which the condition applies does not appropriately reflect an ownership level at which an acquiring fund might be able to influence a shareholder vote. We recommend that these voting provisions instead apply when an acquiring fund and companies it controls hold in the aggregate a higher threshold of shares, such as 10%. We believe such a threshold would more appropriately balance the need to prevent influence of shareholder votes with allowing acquiring funds that do not have the ability to influence acquired funds to participate in shareholder votes.

Finally, the rule would prohibit a fund that acquires more than 3% of an acquired fund's shares from redeeming or tendering for repurchase more than 3% of the acquired fund's total outstanding shares in any 30-day period. The SEC states, however, that acquiring funds that invest in funds listed on an exchange could sell shares in the secondary market without regard to this volume limit, since secondary market transactions would not involve redemptions.<sup>12</sup> We support this approach that the condition would not apply to sales of fund shares in secondary market transactions, and note that most hedge fund sales of ETFs are conducted as secondary market transactions.

### **Private Fund Manager Reporting Can Be Used To Ensure Compliance With the Rule**

In the Proposal, the SEC explains that private funds are not included in the rule because they are not subject to reporting on Form N-CEN and Form N-PORT, or subject to recordkeeping requirements under the Investment Company Act, and as a result the SEC would not have an adequate basis for monitoring compliance with the rule's conditions. We believe, however, that the SEC can ensure private funds comply with the rule through the extensive regulatory and reporting framework applicable to SEC-registered private fund managers.<sup>13</sup>

Registered investment advisers to private funds submit detailed information about private funds they manage on Form ADV, including information about fund of funds arrangements. Form ADV Question 8 in Section 7.B.(1) asks whether a fund is a fund of funds, defined as a fund investing 10% or more of its total assets in either private funds or registered investment companies. Similarly, Question 9 asks whether a private fund has invested in securities issued by registered investment companies, other than money market funds. If needed, the SEC could include a new yes/no question in Form ADV comparable to the proposed new question in Form N-CEN, asking whether a private fund has relied on rule 12d1-4. This approach would be consistent with other questions in Form ADV that ask whether an adviser or private fund is relying on a provision or rule.<sup>14</sup>

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<sup>12</sup> 84 F.R. at 1299.

<sup>13</sup> We note for example, that BDCs, which do not file reports on Form N-CEN, are nevertheless proposed to be included in the rule. *See* 84 F.R. at 1311.

<sup>14</sup> For example, Question 4 in Section 7.B.(1) asks whether a private fund qualifies for the exclusion from the definition of investment company in section 3(c)(1) or section 3(c)(7) of the Investment Company Act. Question 21 asks whether a private fund has ever relied on an exemption from registration under Regulation D of the Securities Act of 1933. We note that any new question on Form ADV should be yes/no, and not include information about fund holdings because Form ADV is publicly available.



Registered investment advisers to private funds also provide the SEC with extensive information on Form PF, which includes information similar to Form N-PORT. The SEC uses Form PF information for a variety of purposes, including systemic risk oversight of private funds and investor protection. The Form includes sensitive portfolio information about private funds that could be used in monitoring compliance with rule 12d1-4. Questions 26 and 30, for example, require that private funds provide monthly information about their investments in registered investment companies.

Institutional investment advisers also already report information about ownership of shares of closed-end investment companies and ETFs on Form 13F.<sup>15</sup> The SEC could use this existing information to assist its oversight of compliance with the ownership limitations in rule 12d1-4 for investments in both closed-end investment companies and ETFs. While Form 13F does not include reporting of ownership of open-end investment companies, we believe the SEC could utilize the information about closed-end funds and ETFs if it were to permit additional private fund investments in ETFs and other funds traded on an exchange.<sup>16</sup>

In addition to the above reporting requirements, registered advisers to private funds are subject to recordkeeping requirements in Rule 204-2 under the Advisers Act. We believe that either by amending Rule 204-2 or through the recordkeeping requirements in rule 12d1-4 that would apply to a fund relying on the rule,<sup>17</sup> the SEC could require registered investment advisers to private funds to maintain records to ensure compliance with the rule.

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MFA appreciates the opportunity to provide these comments in response to the Proposal. If you have any questions about these comments, or if we can provide further information about these issues, please do not hesitate to contact the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Mark D. Epley

Mark D. Epley  
Executive Vice-President & Managing Director,  
General Counsel

/s/ Matthew Newell

Matthew Newell  
Associate General Counsel

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<sup>15</sup> See Division of Investment Management: Frequently Asked Questions About Form 13F, Question 7 (Mar. 15, 2017) at: <https://www.sec.gov/divisions/investment/13ffaq.htm>.

<sup>16</sup> In addition, oversight of these investments would be distinct as compared to investments in open-end funds because secondary market transactions in ETFs would not be subject to redemption limits.

<sup>17</sup> For example, rule 12d1-1 includes recordkeeping requirements that apply to funds relying on the rule similar to the recordkeeping requirements proposed in rule 12d1-4.