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May 2, 2019

Brent J. Fields
Secretary, Securities and Exchange Commission
100 F Street, NE
Washington DC 20549

Re: File Number S7-27-18

Ladies and Gentlemen:

Morningstar welcomes the opportunity to comment on the SEC's proposal on "Fund of Funds Arrangements" (hereafter the Proposed Rule).[1] Morningstar's mission is to help investors reach their financial goals. Because we offer an extensive line of products for individual investors, professional financial advisors, and institutional clients, we have a broad view on the proposed rule and its possible effects for investors. Given the massive increase in target-date fund assets over the past few years that have become the backbone of the defined-contribution system, as well as the fact that many of these target-date funds are funds of funds, the SEC's proposal would have a significant impact on ordinary investors saving for retirement. In 2017, target-date mutual fund assets surpassed $1 trillion following an all-time high of $70 billion in estimated net flows during that same year.[2] Target-date mutual funds have seen "more than $40 billion in net flows each year since 2008."[3] These target-date funds might have to shift to collective investment trusts if they cannot comply with the Proposed Rule, potentially denying retail investors and small plans access to them.

In summary:

- We support the streamlining of the approval process and think that funds of funds should be governed in a standardized manner.
- We support disclosures of fees to help investors navigate layering of funds, and we think the anti-layering provisions proposed by the Commission are too prescriptive.
- We are concerned about the unintended consequences and the liquidity risk management challenges of the 3% threshold. We encourage the Commission to consider whether this threshold is necessary.

We explain each of these issues further below.

Streamlining Promotes Standardization

Morningstar strongly supports the Commission's goal of streamlining the process for the approval of funds of funds. Morningstar supports the greater efficiency and transparency that the

1 SEC. 2019. "Fund of Funds Arrangements." *Federal Register.* Vol. 84, No.22, P. 1286 https://www.govinfo.gov/content/pkg/FR-2019-02-01/pdf/2018-27924.pdf

2 Holt, J., & Larsen, H. 2018. "2018 Target-Date Fund Landscape: Sizing Up the Trillion-Dollar, Increasingly Passive Giant." *Morningstar.* (May 7) https://www.morningstar.com/lp/tdf-landscape?cid=RED_RES0002

3 Ibid.

new Proposed Rule provides. The Proposed Rule will make the process of launching most new funds of funds more efficient and provide more certainty to the marketplace. A uniform, efficient process will allow for more standardization and transparency around these products, which are growing more popular in certain forms - for example, target-date funds.

As the Commission acknowledges, currently, the combination of statutory exemptions, Commission rules, and exemptive orders has created a regulatory regime where substantially similar fund-of-funds arrangements are subject to different conditions.[4] In addition, the Commission acknowledges that a comprehensive, streamlined framework would reduce confusion and subject fund-of-funds arrangements to a tailored set of conditions that would enhance investor protection while also providing funds with investment flexibility to meet their objectives in an efficient manner.[5] The Commission asks whether the exemptive relief should include all registered funds and BDCs within the scope of "acquired funds" and "acquiring funds" as proposed.[6] We think it should. Furthermore, the Commission asks whether it should rescind existing fund-of-fund orders and whether it should revoke the fund-of-funds provisions of the ETF orders and ETMF orders.[7] The Commission notes that the staff in the Division of Investment Management is reviewing staff no-action and interpretative letters relating to section 12(d)(1) to determine whether any such letters should be withdrawn in connection with any adoption of this proposal.[8]

We believe that the Proposed Rule is an opportunity to standardize the landscape for funds of funds. If the Commission is to have a rule, we do not see the benefit of retaining various exemptive relief and interpretations outside of and in addition to the rule. We encourage the Commission to make the Proposed Rule sufficiently broad to encompass the needs of the industry instead of a prescriptive rule that has many exemptions. Such standardization allows for transparency, a level playing field, and easy comparability of funds of funds that are all operating under the same rules.

In general, we agree with the Proposed Rule's approach regarding allowing different fund types to invest in different fund types under a standard set of rules. We commend the Commission on simplifying the fund-of-funds launch process, regardless of the fund type, for the acquiring and acquired fund and for allowing flexibility for both acquiring and acquired funds to be of different types. Generally, Morningstar believes that consistent rules across registered investment company types are beneficial to investors. This aids investors in understanding the operations of registered investment funds. Such standardization will allow investors to compare, for instance, differences across fund types in terms of liquidity of the acquired fund and how that affects the parent fund.

Disclosure Is Preferable to Restricting Anti-layering

4 Proposed Rule, P. 1288.

5 Proposed Rule, P. 1288.

6 Proposed Rule, P. 1291.

7 Proposed Rule, P. 1312.

8 Proposed Rule, P. 1312.

The Proposed Rule would prohibit most three-tier funds subject to limited exceptions. Fund complexes that currently employ a three-tier structure would need to restructure their investments.[9] Though the SEC acknowledges three-tier structures may in certain circumstances provide efficient and cost-effective exposure to particular market segments,[10] it nonetheless seeks to restrict these structures because they can obfuscate the fund's investments, fees, and related risks.[11]

We agree with the Commission's goal of making transparent to investors the fees and risks of a fund. We also note that tiered structures are sometimes utilized to manage costs, for example, through one low-cost acquired fund that provides exposure to a number of acquiring funds instead of replicating the investment strategy in a higher-cost manner. Consequently, the rule as proposed may cause some beneficial products to be eliminated from the marketplace.

We recommend that the Commission approach the risks of anti-layering through disclosure instead of restricting the structures themselves. Currently, expense ratios in annual reports differ from those in prospectuses. The SEC requires funds of funds to disclose in their prospectus fee tables the expenses of funds in which they invest.[12] While the expense ratios for the acquired fund are disclosed in the prospectus, they are not necessarily disclosed in the annual reports. Investment companies should be required to accurately disclose expense ratios, accounting for all layers of the fund, in both the annual report and the prospectus. The prospectus is ex ante and is an estimate of the expense ratio based on the assumed allocation across acquired funds. The annual report is ex post and would provide the most accurate information about the investor's experience and fees.

The 3% Threshold Will Present Challenges for Liquidity Management

The Commission is proposing that, for any acquiring fund owning more than 3% of an acquired fund, redemptions be limited to 3% per any 30-day period.[13] Many acquiring funds own more than 3% of one or more acquired funds. Morningstar estimates that 1,591 of parent funds with market size over $1 billion own more than 3% of an acquired fund.[14] Many of these funds will have to change their investment strategy to meet the Proposed Rule's requirement to redeem only 3% of a fund in a 30-day period. Moreover, these funds include many funds that earn high Morningstar Analyst Ratings; 241 earn a Gold, Silver, or Bronze rating. Further, more than 20% are target-date funds, which are popular among individual investors saving for retirement in 401(k) and IRA plans. The redemption conditions of the proposed rule could be particularly challenging for target-date funds, as they have to purchase and redeem in a manner consistent with their glide-path strategy. This restriction would hinder their strategy. It would also likely give target-date funds incentive to acquire smaller shares of multiple acquired funds rather than larger shares of fewer funds. Such a strategy could add unnecessary costs to investor portfolios

9 Proposed Rule, P. 1328.

10 Proposed Rule, P. 1308.

11 Proposed Rule, P. 1308.

12 SEC. 2006. "Fund of Funds Investments." *Federal Register.* Vol. 71, No.123, P. 36645 (June 7) https://www.govinfo.gov/content/pkg/FR-2006-06-27/pdf/06-5650.pdf.

13 Proposed Rule, P. 1298.

14 We cannot estimate with Morningstar data how many funds rely on the statute directly and are, therefore, not impacted by the Proposed Rule. This number of funds is, therefore, an overestimate of the potential impact of the proposal. We encourage the Commission to determine the true impact of the three percent redemption threshold before proceeding to adoption.

through more transactions, costlier funds, and other challenges that provide no offsetting benefit to investors.

In addition, for all affected funds, this proposed redemption limit may have an adverse impact on acquiring fund liquidity and inhibit current portfolio management techniques. It will force boards to consider trade-offs in product development: They will have to be mindful of liquidity considerations in connection with both product design and ongoing compliance.[15]

For many other acquiring funds, for which redemptions in excess of 3% of an acquired fund's shares are infrequent, the flexibility to redeem is nonetheless essential. The Commission has also not made clear how this requirement would interact with the liquidity rule.[16] Boards of acquiring funds would have significant challenges in monitoring liquidity for acquiring funds in light of the 30-day restriction. Would securities that cannot be redeemed in 30 days have to be deemed illiquid? We do not believe that such an outcome is reasonable. It also creates a preference for certain products, for example, ETFs, which can be redeemed on secondary markets. However, ETFs are not always the best vehicle to be acquired by other funds, such as target-date funds, which are utilized in retirement accounts. They do not serve the tax planning needs for most individuals within tax-preferred retirement vehicles. Putting a tax-efficient fund, like an ETF, in a tax-advantaged account, such as a 401(k), yields no additional benefit. Further, we understand that the Commission seeks to provide investor protection without manipulating investor choices in a way that undermines investor needs. Thus, we do not believe that the Commission intends to create a product preference with this proposal. The 3% threshold for redemptions would create such a preference, as well as the liquidity challenges discussed above. We encourage the Commission to remove this threshold when moving toward a final rule.

We thank the Commission for the opportunity to comment on its proposal on Fund of Funds Arrangements. Should you wish to discuss any of the comments in this letter, please do not hesitate to contact either of us as indicated below:

Jasmin Sethi at [redacted] or [redacted].
Aron Szapiro at [redacted] or [redacted].

Sincerely,

Jasmin Sethi
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Morningstar, Inc.

Aron Szapiro
Director of Policy Research
Morningstar, Inc.

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15 McCabe, B., & Baer, E. 2019. "What to Know About SEC Fund-of-Funds Proposal." *Board IQ.* (Feb 26) http://boardiq.com/c/2210653/269413?referrer_module=SearchSubFromBI&highlight=ropes%20%26%20gray

16 SEC. 2016. 17 CFR §270.22e-4; "Investment Company Liquidity Risk Management Programs." *Federal Register.* Vol. 81, No.223, P. 82142https://www.govinfo.gov/content/pkg/FR-2016-11-18/pdf/2016-25348.pdf