

May 2, 2019



Ms. Vanessa Countryman  
Acting Director, Office of the Secretary  
Securities and Exchange Commission  
100 F Street N.E.  
Washington, D.C. 20549-1090

RE: File Number S7-27-18, Fund of Funds Arrangements

Dear Madam:

Charles Schwab Investment Management (“CSIM”)<sup>1</sup> appreciates the opportunity to offer comments on the Securities and Exchange Commission’s (the “Commission”) proposed Rule 12d1-4 for fund of funds arrangements (the “Proposed Rule”).<sup>2</sup>

CSIM is one of the largest asset managers in the nation, offering individual investors a variety of products to meet their investing goals, including equity and fixed-income mutual funds and exchange-traded funds, money market funds, target-date funds and other products. Like most asset managers, CSIM manages registered investment companies that invest in shares of other investment companies: funds of funds. Currently, CSIM manages 33 funds of funds, with assets of approximately \$8.4 billion as of March 31, 2019. CSIM utilizes funds of funds in a variety of situations, including target-date funds, target-risk funds, balanced funds, monthly income funds and insurance-dedicated funds of funds offered through insurance company separate account products.

As the Commission notes in the Proposed Rule, “Funds increasingly invest in other funds as a way to achieve asset allocation [and] diversification...to gain exposure to a particular market or asset class in an efficient manner...[or] to equitize cash, engage in hedging transactions, or manage risk.”<sup>3</sup> CSIM also agrees with the Commission’s observations on the important role fund of funds arrangements can play for individual investors:

Main Street investors similarly use fund of funds arrangements as a convenient way to allocate and diversify their investment through a single, professionally managed portfolio. For example, a fund of funds may provide an investor with the same benefits as separate direct investments in several underlying funds, without the increased monitoring and

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<sup>1</sup> Founded in 1989, CSIM, a subsidiary of The Charles Schwab Corporation, is one of the nation’s largest asset management companies, with more than \$400 billion in assets under management as of 03/31/19. It is among the country’s largest money market fund managers (based on assets under management). It is also the third-largest provider of index mutual funds and the fifth-largest provider of ETFs (Source: Strategic Insight as of 03/31/19; based on assets under management). More information about CSIM and the products it manages is available at [schwabfunds.com](http://schwabfunds.com).

<sup>2</sup> Fund of Funds Arrangements, Release Nos. 33-10590; IC-33329. 84 Fed. Reg. (February 1, 2019), at 1286.

<sup>3</sup> 84 Fed. Reg., at 1287.

recordkeeping that could accompany investments in each underlying fund. In addition, a fund of funds may provide an investor with exposure to an asset class or fund that may not be otherwise available to that investor.<sup>4</sup>

Importantly, many retail investors invest in funds of funds through their retirement plans, including by choosing to invest in target-date funds. Funds of funds can provide investors, regardless of the investor's sophistication or knowledge, access to broad portfolio diversification and rebalancing that can be critically important for retirement saving.

CSIM offers both fund of funds products that use only affiliated funds and products that invest in a mix of affiliated acquired funds and unaffiliated acquired funds managed by third parties. Our funds of funds implement their investment strategies through both active and passive acquired funds utilizing mutual funds and exchange-traded funds as underlying investments. Investors have a wide variety of needs and there are a wide variety of products in the marketplace to meet those needs; we believe investors should not be limited to affiliated products only. The use of both affiliated and unaffiliated funds provides investors with choice and access to different investment managers, potentially enhancing diversification while providing exposure to different investment styles and strategies that are not always accessible exclusively through proprietary products. To that end, CSIM seeks to incorporate into several of its fund of funds products third-party fund strategies that complement or supplement CSIM-advised funds.

### **Executive Summary**

CSIM supports the overall goals of the Proposed Rule. Many aspects of the Proposed Rule will simplify regulation, allow fund companies to continue to innovate and bring new products to the market, and bring long overdue benefits to individual investors. CSIM, however, does have a number of suggestions and recommendations to improve the Proposed Rule. Our recommendations will focus on the following:

- The proposed rescission of Rule 12d1-2 unnecessarily limits the investment options for funds of funds and should be reconsidered or modified;
- The Commission should consider revising the proposed definition of “control” and its impact on voting to better align with real-world concerns;
- The Commission should reconsider the proposed redemption limit and revise it using our suggestions; and
- The Commission should exempt affiliated acquired funds from redemption limits.

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<sup>4</sup> 84 Fed. Reg., at 1287.

## Support for the Goals of the Proposed Rule

As noted above, CSIM supports the overall goals of the Proposed Rule. Like other asset managers, CSIM relies on SEC Exemptive Orders<sup>5</sup> that provide relief from certain provisions of Sections 12(d)(1) of the Investment Company Act of 1940 for operating its funds of funds. In addition, Schwab ETFs rely on Exemptive Orders<sup>6</sup> that provide relief from provisions of Section 12(d)(1) that allow other asset managers to operate funds of funds utilizing Schwab ETFs. The SEC rule proposal will level the playing field by creating a new Rule 12d1-4, thereby ending the patchwork quilt of exemptive orders that has resulted in different rules for substantially similar funds of funds. CSIM agrees with the Commission’s observation that 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.”<sup>7</sup> The harmonization of the different standards for fund of funds arrangements will be a benefit to fund companies, individual investors and regulators alike.

Of particular importance to individual investors is the proposed rule’s expansion of the universe of permitted fund of funds arrangements. The Proposed Rule, for example, would allow open-end funds to invest in listed and unlisted closed-end funds, as well as listed and unlisted business development companies. This increase in options should benefit individual investors by further widening the investment strategies to which they have access.

While CSIM applauds the intention of the Proposed Rule and believes that individual investors would benefit from the streamlining of the regulatory landscape for funds of funds, the firm recommends reconsidering several aspects of the Proposed Rule that CSIM believes undermine that laudable goal and are not in the best interest of individual investors.

## Rescission of Rule 12d1-2

CSIM is concerned that the Proposed Rule would rescind Rule 12d1-2, as well as related No-Action Letters,<sup>8</sup> thereby removing the ability of an affiliated fund of funds relying on Section 12(d)(1)(G) to invest in individual securities and derivatives, as well as unaffiliated funds and money market funds. It is not clear to us what problem or investor protection concern this proposal is trying to address. Rescission of Rule 12d1-2 would mean that a fund of funds investing solely in affiliated acquired funds that chooses to invest in even a single security would be subject to all of the requirements of the Proposed Rule. The Proposed Rule would then have the effect of limiting the investment options available to a fund of funds, which is not in the best

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<sup>5</sup> Schwab Capital Trust, *et al.*, Investment Company Act Release Nos. 24067 (Oct. 1, 1999) (Notice) and 24113 (Oct. 27, 1999) (Order); Schwab Capital Trust, *et al.*, Investment Company Act Release Nos. 21726 (Jan. 31, 1996) (Notice) and 21788 (Feb. 27, 1996) (Order).

<sup>6</sup> Charles Schwab Investment Management, Inc., *et al.*, Investment Company Act Release Nos. 28933 (Sep. 28, 2009) (Notice) and 28983 (Oct. 23, 2009) (Order); Charles Schwab Investment Management, Inc., *et al.*, Investment Company Act Release Nos. 32014 (Feb. 29, 2016) (Notice) and 32052 (March 25, 2016) (Order); Charles Schwab Investment Management, Inc., *et al.*, Investment Company Act Release Nos. 30584 (June 27, 2013) (Notice) and 30606 (July 23, 2013) (Order).

<sup>7</sup> 84 Fed. Reg., at 1288.

<sup>8</sup> For example, the Commission’s 2015 staff no-action letter for Northern Lights Fund Trust (available at <https://www.sec.gov/divisions/investment/noaction/2015/northern-lights-fund-trust-063015.htm>).

interest of individual investors. Moreover, it runs counter to the Proposed Rule's goal of expanding the investment options open to funds of funds. We suggest the Commission reconsider rescinding Rule 12d1-2. Alternatively, the Commission should amend Section 12(d)(1)(G) to allow affiliated funds of funds to invest in unaffiliated money market funds, individual securities and derivatives.

### **Control and Voting**

CSIM is also concerned that the Proposed Rule requires that an acquiring fund must use either pass-through voting or mirror voting if it and its advisory group hold, in aggregate, more than 3% of the outstanding voting securities of an acquired fund.<sup>9</sup> Current rules define "control" as ownership of more than 25% of the voting securities and our current exemptive orders only require mirror voting when a fund and its advisory group hold, in aggregate, more than 25% of the outstanding voting securities of an acquired fund. The Proposed Rule does not identify a real-world concern that warrants this dramatic reduction, which would substantially increase the administrative burden and potentially dilute shareholders' ability to benefit from proxy policy. Generally speaking, the expense and logistical challenges make pass-through voting impractical. Consequently, current CSIM policy states that we will mirror vote when necessary. We strongly support the comments of the Investment Company Institute (ICI)<sup>10</sup> on these points.

### **Redemption Limit Should Be Revised**

CSIM's most significant concern is that the redemption limits in the Proposed Rule would undermine the goals of the rule itself and are not in the best interest of either funds or individual investors. We believe the Commission should consider our recommended alternatives to better address its concerns. The proposed rule would "prohibit 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."<sup>11</sup> While CSIM understands and supports the SEC's goal of ensuring that an acquiring fund cannot exercise undue control or influence over an acquired fund, the redemption limit could constrain the fund's advisor from meeting its fiduciary duty in effecting redemptions from the fund of funds, impairing its ability to manage the fund in accordance with its investment and asset allocation strategies.

CSIM believes strongly that the Commission should reconsider the proposed redemption limit for a variety of reasons. The 3% redemption limit appears to be an arbitrary designation. In the fund of funds world, it is not unusual for an acquiring fund to own more than 3% of the total outstanding shares of an acquired fund. The Commission's own data shows that 809 out of 4,342 acquiring funds, or 18.6%, held more than 3% of an acquired fund's total outstanding shares in a June 2018 analysis.<sup>12</sup> The Commission's data, however, is specific to a particular moment in time; the percentage of funds of funds whose ownership of an acquired fund exceeds

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<sup>9</sup> 84 Fed. Reg., at 1295.

<sup>10</sup> Comment letter of Paul Schott Stevens, Investment Company Institute, April 30, 2019. Available at: <https://www.sec.gov/comments/s7-27-18/s72718-5433908-184637.pdf>.

<sup>11</sup> 84 Fed. Reg., at 1298.

<sup>12</sup> 84 Fed. Reg., at 1320.

3% of total outstanding shares rises and falls according to a variety of market and other circumstances. At CSIM, of our 33 funds of funds, 13 have owned more than 3% of an acquired fund at one time or another. It is important to note that it is common for a fund of funds to inadvertently hold more than 3% of an acquired fund due to actions of other investors in the acquired fund. For example, if a large pension fund redeems all of its shares in an acquired fund as part of a rebalancing or a change in strategy, the other shareholders of that acquired fund may find themselves holding more than 3% of the fund.

CSIM has a recent real-world experience that illustrates how such a situation might arise. In March 2019, CSIM's fund of funds portfolio management team experienced a complicating situation in a third-party fund that CSIM's fund of funds originally purchased in 2009. At the time of purchase, aggregate ownership share by CSIM-advised funds was well below 25%. Over time, our ownership share gradually increased due to third-party investor redemptions and CSIM's increasing fund of funds assets, but remained below the 25% threshold. Near the end of March 2019, our portfolio management team identified that our aggregate ownership share of the third-party fund increased from under 25% to over 32% in the course of a single trading day. Our team worked to identify whether the data was accurately reported, contacted the manager, and ultimately confirmed that a large redemption in the third-party fund had occurred. This is an illustration of how the action of other investors can dramatically impact the ownership percentage of an acquired fund, a fact that generally only can be discovered after the action of other investors has taken place.

Importantly, this example helps to illustrate how, solely as a result of other investors' actions in the acquired fund, the fund of fund's ability to redeem from this third-party fund would have been dramatically impacted under the proposed redemption rule. CSIM's redemption period would increase considerably, significantly delaying the team's ability to take action and potentially harming individual investors. We believe this recent example illustrates the potential difficulties of managing to the proposed redemption rule, regardless of percentage threshold established, and incents managers to focus on larger strategies that limit risks to redemption timeframes.

The Proposed Rule would hamper the ability of an acquiring fund to redeem out of an acquired fund in a timely manner. Even in times of market stability, there are ample reasons an acquiring fund might want to redeem quickly out of an acquired fund, including a poor performing manager, a change in the fund's management or a firm announcement that negatively impacts the fund. Depending on the size of the ownership percentage, it could potentially take months to fully redeem out of the underperforming fund. Other investors – high net-worth individuals, defined benefit plans, defined contribution plans, Collective Investment Trusts, institutional managed account platforms (“robo-advisers”) – would not have such limitations, potentially worsening the situation for the fund of funds stuck holding the underperforming investment. Indeed, this could result in a spiral in which the fund of funds is limited in its redemptions, yet redemptions by other shareholders continue to keep the fund's holding above 3%, dramatically extending its time to liquidate. Liquidation of a fund of funds would be extremely difficult because it could take months to redeem out of each acquired fund, potentially harming shareholders, even after the fund of funds' management and Board of Trustees has determined liquidation is in the best interest of shareholders.

The risk of such a situation would discourage investment in smaller funds, instead encouraging investment in larger, established funds for which the risk of crossing the 3% ownership threshold is much smaller. This result appears to fundamentally contradict the Commission's goal of creating a level playing field and instead fosters an environment where larger, more established funds, and therefore investment managers, may be favored across the fund of funds landscape. As the Commission observes, "acquiring funds may favor investments in larger acquired fund because it would be easier to stay below 3% of the acquired fund's outstanding securities and thus not trigger the 3% redemption limit when investing in larger rather than smaller acquired funds."<sup>13</sup> This is not in the best interest of investors because it reduces the investment options available to a fund of funds investment manager. The Commission has long expressed concern in a variety of contexts that consolidation within the industry has made it harder for smaller funds and investment managers to succeed; the Proposed Rule appears to exacerbate, rather than address, that concern.

Another impact of the Proposed Rule as currently drafted is that it would favor exchange-traded funds over other types of products, since exchange-traded funds can be sold on the secondary market without regard to the 3% share ownership limit. While CSIM has long championed exchange-traded funds as an important, low-cost investment option for individual investors, it is rare for the Commission to approve a rule that clearly favors one type of product over other products. In this situation, the Proposed Rule's likely outcome runs counter to both the long-standing Commission principle of remaining product-neutral but also to the Proposed Rule's stated goal of leveling the playing field in the fund of funds space. While it is difficult to say prior to the implementation of a final rule exactly how CSIM would react, it is quite possible that the firm would choose to invest in larger funds or in more exchange-traded funds in order to either avoid the 3% threshold entirely or at least reduce the likelihood of triggering it. As noted above, either outcome limits the investment options available to investors in the fund of funds, which CSIM does not believe is in the best interest of investors. Under the Proposed Rule, the size of the acquired fund takes on outsize importance compared to other important factors like the investment strategy and performance of the fund.

The Proposed Rule may also create a mismatch in liquidity between the acquiring fund and the acquired fund. Under the fund of funds liquidity risk management program, a redemption limitation effectively deems an acquired fund an illiquid security whenever a fund of funds owns more than 3% of the acquired fund, since the acquiring fund would be prohibited from redeeming more than 3% of shares of the acquired fund within the prescribed time period described in the Proposed Rule. For example, CSIM's largest 401(k) plan sponsor client represents assets totaling 14% of one target-date fund series. Other CSIM target-date series have single 401(k) plan sponsor assets totaling over 3% as well. Under the proposal, these larger relationships may pose challenges for CSIM's funds of funds to maintain their intended policy weights if the plan sponsor elected to redeem from a fund of funds. If the acquiring fund is limited in its ability to reduce its positions in smaller acquired funds, it may be forced to reduce its positions in larger acquired funds in other asset classes, potentially resulting in unwanted changes to its desired asset allocation. In periods of market stress, this liquidity mismatch could reverberate across the industry, exacerbating volatility. As noted earlier, a market event that

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<sup>13</sup> 84 Fed. Reg., at 1325.

triggers large-scale redemptions by an individual investor and/or an institutional investor (such as a retirement plan) could result in a fund of funds suddenly holding more than 3% of the acquired fund, leaving the fund of funds unable to adequately react to the event.

The proposed 3% limit would fundamentally change the ability to execute and manage to the fund of funds' investment strategy. Any time the fund of funds approached the 3% limit on one of its underlying holdings, the fund manager would likely manage the fund in a way that ensures the ownership level is not breached, regardless of whether doing so supports the optimal outcome for individual investors. It would encourage funds of funds to invest in larger acquired funds, or a larger number of acquired funds, complicating management and potentially increasing the cost to individual investors. The Commission acknowledges this in the Proposed Rule:

To the extent that the rule proposal would require some existing funds of funds to change their portfolios to ensure compliance with the rule proposal, portfolio changes could: (i) impose transaction costs on acquiring funds; (ii) force acquiring funds to sell the shares of acquired funds at potentially depressed prices; (iii) disrupt the acquiring funds' investment strategy; (iv) impose liquidity demands on acquired funds as a result of the acquiring fund redemptions; and (v) have tax implications, which would depend on whether the acquiring fund would sell appreciated or depreciated shares of acquired funds.<sup>14</sup>

CSIM strongly agrees with this assessment of the impacts, none of which are favorable for individual investors. Yet the Commission appears uncharacteristically dismissive of these concerns.

In sum, CSIM objects to the arbitrary nature of the 3% redemption limit. The limit fails to allow consideration of individual facts and circumstances. By virtue of a single large redemption by a retirement plan, an institutional investor, a registered investment advisor or an individual investor, the redemption limit could constrain the fund's advisor from meeting its fiduciary duty in effecting that redemption, impairing its ability to manage the fund in accordance with its investment and asset allocation strategies. It ignores the possibility that an acquired fund can accommodate a larger redemption where there is no evidence of control issues or concerns of undue influence. Such a transaction, if it is not harmful to the acquired fund, could be beneficial to the acquiring fund and its investors. There are simply too many circumstances in which an arbitrary redemption limit penalizes individual investors.

### **Potential Alternatives to the 3% Redemption Limit**

To address the concerns raised by the Commission in the Proposed Rule, CSIM recommends consideration of the following alternatives to the proposed redemption limit:

*Discretionary Redemption Limits* – CSIM suggests that the SEC consider permitting the fund company to determine the redemption limit that is appropriate for each fund, with approval from the fund's Board of Trustees (the "Board"). Any redemption limits in the final Rule should reflect management and the Board's judgment and be discretionary, such that the acquired fund

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<sup>14</sup> 84 Fed. Reg., at 1321.

may choose whether or not to enforce a redemption limit. Unaffiliated funds already have such an option: the 1% discretionary redemption limit available under Rule 12(d)(1)(F). CSIM believes that discretionary redemption limits still provide protections to the acquired fund against undue influence, control or untimely large redemptions. It also would afford both acquiring funds and acquired funds more flexibility to adapt to different scenarios and establish policies consistent with the liquidity requirements of the acquired fund based upon the investment strategy, asset class and other such fund-specific parameters as the fund's investment advisor determined to be appropriate. Board oversight would help ensure that undue influence or control is avoided. CSIM's preference would be to have discretionary limits per fund, but if the Commission is not amenable to that solution, we would support a specific limit as long as it is discretionary.

*Required Pre-Notification of Large Trades* – CSIM also proposes that the SEC consider requiring pre-notification of large trades when a fund of funds trades greater than a certain percentage (such as 5%) of the acquired fund. The rule should provide a recommended pre-notification period of three days to allow the acquired fund time to prepare and, if necessary, adjust its holdings in anticipation of the large redemption. We would also recommend that the acquired fund be afforded in any rule the opportunity to waive the pre-notification process at its discretion, if it determines the transaction can be accommodated without adverse impact on the fund. Pre-notification, if implemented, would make the existing 30-day limit unnecessary.

*Higher redemption limit* – While CSIM does not advocate an arbitrary redemption limit, preferring instead to make the limit discretionary, if the Commission is committed to a redemption limit CSIM recommends the limit be substantially increased. An increased limit is still an arbitrary limit, albeit one that would subject fewer funds to its repercussions.

We recognize that the Commission may be concerned that a discretionary limit may not be sufficient to mitigate the possibility of an acquiring fund exerting undue influence or control through threat of large redemptions. However, we do not believe that an acquired fund would neglect its fiduciary duty and choose to exercise its discretion where allowing redemptions in excess of the fund's redemption limit is adverse to the best interests of the fund and its shareholders. Moreover, the use of discretion should be subject to compliance review and oversight and reportable to the fund's Board of Trustees. Further, by allowing each fund to set its own redemption limit, the threshold will be more relevant to that fund's individual liquidity framework and other circumstances, such that it is a more reasonable point at which to evaluate the impact of a proposed redemption exceeding the threshold. Notably, this fund-by-fund approach is consistent with the SEC's liquidity risk framework, which similarly requires a fund-by-fund assessment. Finally, the pre-notification requirements help afford the acquired fund sufficient time to evaluate the potential impact of a proposed redemption and determine whether to enforce the redemption limit.

### **Redemption Limit Should Not Apply to Affiliated Acquired Funds**

Under the Proposed Rule, once the investment of a fund of funds exceeds 3% of the total outstanding shares of an unaffiliated acquired fund, the fund of funds would no longer be permitted to rely on Section 12(d)(1)(G) and would automatically become subject to the



requirements of the proposed Rule 12d1-4. At that point, the 3% redemption limit would then apply to both unaffiliated and affiliated funds. With investments in affiliated funds that share a similar advisor, the advisor has a fiduciary duty to both the acquiring fund and the acquired fund. In such situations, control and other undue influence concerns do not exist with regard to the investments in affiliated acquired funds. Indeed, in the Control section of the Proposed Rule, affiliated funds are exempted from the proposed requirements for exactly this reason: “In circumstances where the acquiring fund and the acquired fund share the same adviser, the adviser would owe a fiduciary duty to both funds, serving to protect the best interests of each fund.”<sup>15</sup> We suggest that the Commission make the same standard apply to the Redemptions section of the Proposed Rule and exempt affiliated acquired funds from the 3% redemption limit.

## **Conclusion**

CSIM applauds the Commission for its important effort to level the playing field for fund of funds arrangements by harmonizing the standards under a single rule and eliminating the current patchwork quilt of rules, no-action letters and exemptive orders. As outlined above, however, we have serious concerns that some aspects of the Proposed Rule will undermine the Commission’s efforts to achieve that result. Thank you very much for allowing us to offer our perspective. CSIM would be pleased to answer any questions or provide any additional information that would be helpful as the Commission moves toward a final rule.

Sincerely,



Jonathan de St Paer  
Chief Executive Officer  
Charles Schwab Investment Management

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<sup>15</sup> 84 Fed. Reg., at 1297.