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Fidelity INVESTMENTS

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Submitted electronically through http://www.regulations.gov

Ms. Vanessa Countryman
Acting Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: **Fund of Funds Arrangements: File Number S7-27-18**

Dear Ms. Countryman:

Fidelity Investments ("Fidelity")[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission ("SEC" or "Commission") on proposed Rule 12d1-4 and related amendments under the Investment Company Act of 1940 (the "1940 Act") intended to enhance and streamline the regulation of funds that invest in other funds ("funds of funds" or "fund of funds arrangements"), subject to certain conditions (the "Proposal").[2]

Fidelity understands firsthand the benefits that fund of funds arrangements can offer a fund and its shareholders, and we appreciate the SEC's efforts to expand, simplify and standardize the current regulatory framework. However, we believe that the Proposal, which significantly alters the existing capabilities of, and requirements for, fund of funds arrangements long established under exemptive relief and existing SEC rules, may result in many of these arrangements being restructured or eliminated, without any commensurate benefit to funds or their shareholders. Our comments below reflect our extensive experience, over more than 20 years, with fund of funds arrangements that are offered to our retail, institutional, workplace and managed account clients.

I. EXECUTIVE SUMMARY

While we appreciate the SEC's efforts to streamline the existing regulatory framework for funds of funds, we are concerned that the Proposal would place funds of funds at a significant disadvantage relative to other acquired fund shareholders, including large institutional investors that are not organized as investment companies. As the Proposing Release acknowledges, many

[1] Fidelity is one of the world's largest providers of financial services, including investment management, retirement planning, portfolio guidance, brokerage, benefits outsourcing and many other financial products and services to more than 27 million individuals and institutions, as well as through 12,500 financial intermediary firms. Fidelity submits this letter on behalf of Strategic Advisers LLC, and Fidelity Management & Research Company and FMR Co., Inc., the investment advisers to the Fidelity family of mutual funds.

[2] Fund of Funds Arrangements, Release Nos. 33–10590; IC–33329; 84 Fed. Reg. 1286 (February 1, 2019), *available at* https://www.govinfo.gov/content/pkg/FR-2019-02-01/pdf/2018-27924.pdf (the "Proposing Release").

funds of funds are designed to allow smaller investors, who otherwise may not have the ability to create a diversified portfolio or have enough assets to afford professional advice, easy access to diversified, professionally managed portfolios.[3] Given the SEC's focus on supporting main street investors, we believe this is not the intended result. Accordingly, we recommend the following modifications that we believe will fulfill the Commission's objective, without disrupting the long-standing funds of funds framework that has functioned to the benefit of funds and shareholders for decades:

- *Codify Existing Conditions*. We recommend that the SEC codify the conditions in funds of funds exemptive orders, which are identified in the Proposing Release, instead of creating new conditions such as the redemption limit. We believe these existing conditions, many of which have been effectively used for decades, have proven their effectiveness in addressing SEC and Congressional concerns underlying Section 12(d)(1).
- *Maintain Existing Exemptive Orders.* Alternatively, we recommend that the SEC allow funds of funds to either operate under their existing exemptive orders or comply with the proposed rule. At a minimum, we believe that the SEC should allow funds of funds that are captive to an affiliated managed account program to maintain their existing exemptive orders due to their unique structure.
- *Eliminate or Modify the Redemption Limit Condition.* If the SEC adopts the framework of Rule 12d1-4 as proposed, we recommend that the redemption limit, which is not included in existing funds of funds' exemptive orders, be eliminated. However, should the Commission retain a redemption limit, we recommend that the SEC exclude fund of funds arrangements utilizing affiliated funds, captive funds of funds to affiliated managed account programs, or in-kind redemptions from compliance with this condition, because these situations do not raise the risk of undue influence that Section 12(d)(1) seeks to address. We also recommend that the SEC permit an acquiring fund to either comply with a redemption limit, or alternatively enter into a participation agreement with an unaffiliated acquired fund.
- *Do Not Rescind Rule 12d1-2*. Rule 12d1-2 provides funds of funds flexibility to meet their investment objectives and enables greater diversification. Accordingly, we believe the SEC should retain Rule 12d1-2 and codify the ability to invest in securities and other investments (such as futures contracts) that currently exists in exemptive orders and broadly relied upon SEC no-action relief.
- *Permit Certain Types of Multi-Tier Structures*. We recommend that the SEC continue to permit multi-tier structures that utilize dedicated funds that are part of the same group of investment companies as the top-level funds, provided that management fees, sales loads, redemption fees and 12b-1 fees are charged only at one level (or to the extent that any management fees are charged at more than one level, it is for

[3] *See* Proposing Release at 1287. In fact, Fidelity's first funds of funds, the Freedom Funds, launched in 1996, were designed to meet demand from retirement plan sponsors and intermediaries for a product that would give plan participants access to diversified portfolios designed for anticipated retirement dates. Before the advent of target date funds, many retirement investors would invest in only one or two plan options, including company stock.

different services being provided to a fund). We believe these types of arrangements provide benefits for funds and do not implicate the concerns underlying Section 12(d)(1).

- *Narrow the Registration Statement Disclosure Requirement*. We are concerned that the proposed disclosure requirement may result in operational issues and could limit the universe of funds available for investment. We recommend that the SEC limit its proposed disclosure requirement to funds that have a principal investment strategy of investing in other funds or alternatively allow funds to rely on a similar representation in a participation agreement.

II. BACKGROUND

Fidelity offers investors a variety of fund of funds structures to serve different investment needs and deliver a range of diversified portfolio strategies. For example, Fidelity utilizes fund of funds arrangements in our target date and target risk products, to achieve exposure to certain asset classes and for cash management purposes. We also use funds of funds as dedicated building blocks to deliver personalized investment products to clients of its managed account program. The following provides additional detail on Fidelity's uses of funds of funds, many of which will be impacted by the Proposal.

A. Fidelity's Target Date Funds and Other Asset Allocation Products

Fidelity's Global Asset Allocation Division is responsible for Fidelity's asset allocation products, including target date funds, which as of February 28, 2019 totaled $446 billion in assets under management. Fidelity offers a wide range of asset allocation products designed to help clients meet their investment goals and services a broad spectrum of Fidelity's diverse client base, including retail, institutional and workplace investors. These products (collectively referred to as the "GAA Funds") include:

- Fidelity Freedom® Funds – Fidelity's flagship target date products and one of the nation's first target date offerings and our largest funds of funds product line with over $180 billion in assets;
- Fidelity Asset Manager® Funds – A suite of target risk funds that offer diversified single-fund strategies based on an investor's risk tolerance with approximately $43 billion in assets;
- Fidelity Advisor Freedom® Funds – Target date funds offered through financial advisers, intermediaries, and broker-dealers with approximately $18 billion in assets;
- Fidelity Freedom® Index Funds – Target date funds that invest in underlying index funds with assets of approximately $31 billion; and
- Fidelity Freedom® Blend Funds – Target date funds that invest in a combination of underlying index funds and active funds with assets of approximately $160 million.[4]

[4] Assets are as of February 28, 2019. Other GAA Funds include products that (i) are sold exclusively to separate accounts of insurance companies, including Fidelity Variable Insurance Products: FundsManager Portfolios®, Freedom Portfolios, Freedom Lifetime Income Portfolios®, and Investor Freedom Portfolios®; (ii) are designed to

The Global Asset Allocation Division also manages multi-asset products for various institutional clients as well as clients in Canada.

Although the investment structure varies, in general, the GAA Funds seek to achieve their investment objective by investing predominantly in other Fidelity funds. In addition, these funds reserve the ability to invest a portion of their assets in futures, ETFs and Treasuries primarily to manage liquidity and cash flows, remain fully invested, or facilitate asset allocation, as applicable.[5] Some of the GAA Funds charge a management fee, but invest in acquired funds that do not charge a management fee, while other products only impose management fees at the acquired fund level that are indirectly borne by the acquiring fund as "acquired fund fees and expenses." In limited circumstances, a management fee may be charged at both the GAA Fund and acquired fund level to compensate each fund's adviser for different services being provided to a fund. Regardless of the structure, Fidelity has designed the fee arrangements for these products to prevent duplication.

B. Fidelity's Use of Funds of Funds for our Managed Account Products

Fidelity offers a range of managed account products, but our flagship offering is the "Fidelity Portfolio Advisory Services or "PAS", a discretionary mutual fund asset allocation service for which clients pay an annual wrap fee based on account assets under management.[6] Fidelity Personal and Workplace Advisors LLC, the sponsor of PAS, has engaged Strategic Advisers LLC ("Strategic"), an affiliated registered adviser, to provide the day-to-day discretionary portfolio management of the PAS accounts, including investment selection of mutual funds, exchange-traded products, and for certain taxable accounts, individual securities.[7] According to Cerulli Associates, Fidelity has the largest market share of the mutual fund advisory wrap industry (19.3%) based on assets as of December 31, 2018.[8] Since the program was launched in 1989, the number of PAS client accounts, which include both taxable and tax-advantaged Individual Retirement Accounts, has grown to over 820,000 with approximately $296 billion in assets under management as of February 28, 2019.

help customers in retirement spend their savings at a rate that maximizes income while preserving principal over time, called Fidelity Managed Retirement Funds®; (iii) assist retirement customers looking for a simple solution to the complexities associated with the IRS-mandated required minimum distributions, called Fidelity Simplicity RMD Funds®; and (iv) are target date funds available to certain fee-based accounts offered by Fidelity, called Fidelity Flex® Freedom Funds.

[5] From time to time these products may also purchase shares of unaffiliated ETFs to gain specific targeted exposures. Collectively, these acquisitions are made in reliance on Rule 12d1-2 under the 1940 Act.

[6] The PAS program is also marketed as "Fidelity Wealth Services."

[7] Each PAS account is typically invested on a discretionary basis to align with an asset allocation and/or investment preference and strategies selected by the PAS client, and is subject to ongoing management and rebalancing, as appropriate, to maintain such alignment. Each client must invest and maintain a minimum of $50,000 in at least one program account to be eligible to participate in the PAS program.

[8] Money Management Institute & Cerulli Associates, *Advisory Solutions Quarterly* (4Q 2018). Industry-wide mutual fund advisory program assets as of December 31, 2018 totaled approximately $1.3 trillion.

In 2005, to improve managed account portfolio construction, Fidelity launched funds of funds advised by Strategic ("PAS Funds"), which were designed to replace many directly-held mutual fund positions in the PAS accounts. The PAS Funds, which are unavailable for purchase by the general public and currently captive to the PAS program, allow Strategic to manage a broad range of funds more efficiently and allocate these funds to PAS accounts more consistently.[9] The PAS Funds, which have combined assets of approximately $170 billion as of February 28, 2019, invest in a combination of underlying affiliated and unaffiliated equity, fixed-income and short-term bond mutual funds and exchange-traded funds. Each PAS Fund also invests directly in individual securities through one or more of the 30 affiliated and unaffiliated sub-advisers that Strategic oversees.[10] Four of the 14 funds primarily invest in affiliated Fidelity funds and rely on Section 12(d)(1)(G) of the 1940 Act and Rule 12d1-2 thereunder to exceed the statutory limits on fund investments and invest directly in securities. The remaining 10 funds are "open architecture" funds that rely on an exemptive order issued by the Commission in 2008 to make substantial investments in both affiliated and unaffiliated investment companies.[11]

Each PAS Fund currently pays a management fee rate equal to the sum of (i) an annual rate payable to Strategic; and (ii) the annual total fees payable to the funded sub-advisers, subject to a maximum aggregate annual management fee rate. Strategic currently contractually waives its entire portion of the management fee payable to it by each fund. Currently, any fees that are paid to Strategic or any of its affiliates by any PAS Fund or underlying fund (affiliated or unaffiliated) for advisory, distribution or other services as a result of a PAS Fund's investment in an underlying fund are credited back to the PAS client against the wrap fee charged to the client. The crediting mechanism is applied to both taxable and tax-advantaged accounts.

III. ALTERNATIVE APPROACHES TO THE PROPOSED RULE

A. Codify the Conditions in Existing Funds of Funds Exemptive Orders Instead of Creating New Conditions under the Proposal

We strongly recommend that the Commission codify the conditions in its fund of funds exemptive orders instead of creating new conditions for funds of funds under the Proposal. We believe this approach achieves the SEC's goal of streamlining the current regulatory regime by codifying the conditions into a single rule, while addressing Congress' investor protection

[9] The PAS Funds constitute approximately 57% of the total assets (74% of the retirement assets, and 10% of the taxable assets) in the PAS program as of February 28, 2019.

[10] Strategic relies on a "manager of managers" exemptive order that allows it, subject to the approval of the PAS Funds' Board of Trustees, to enter into new or amended sub-advisory agreements with one or more unaffiliated sub-advisers without obtaining shareholder approval of such agreements. Subject to oversight by the PAS Funds' Board, Strategic has the ultimate responsibility of overseeing the funds' sub-advisers and recommending their hiring, termination, and replacement. *In re* Fidelity Management & Research Company et al., Investment Company Act Release Nos. 27544 (Nov. 2, 2006) (Notice) and 27585 (Nov. 28, 2006) (order).

[11] Fidelity Rutland Square Trust, et al., Investment Company Act Release Nos. 28259 (April 30, 2008) (Notice) and 28287 (May 28, 2008) (Order) and related application ("Fidelity Rutland").

concerns.[12] By codifying the core conditions issued in the Commission's line of exemptive orders, the Commission can continue to effectively limit the ability of acquiring funds to unduly influence acquired funds without disturbing funds that have operated under these conditions for years. Although the SEC cites to cost savings associated with removing unnecessary conditions from existing exemptive orders, we believe these savings would not outweigh the potential impact to funds that would be introduced by the Proposal, which we discuss in detail below.[13]

In its Proposing Release, the SEC also expressed concerns that a codification approach would not fully address the potential for an acquiring fund to exert undue influence over an acquired fund due to a lack of restriction on quick redemptions, which may create liquidity and investment flexibility issues for acquired funds.[14] We do not believe this to be the case. Fund of funds exemptive orders commonly contain a condition that prohibits an acquiring fund (or its affiliates) from causing any existing or potential investment to influence the terms of any services or transactions between the acquiring fund and the unaffiliated acquired funds or their affiliates, which would include the threat of a quick, large-scale redemption to induce a concession from any acquired fund.[15] We believe that the lack of any recent regulatory action or widespread use of coercive redemption activity speaks to the effectiveness of this and other

[12] Although there is some variation in the funds of funds exemptive orders, they generally share the same core conditions, which are identified by the SEC in the Proposing Release, and relate to (i) voting, (ii) board findings and procedures, (iii) participation agreements, (iv) limits on three-tier structures, and (v) layering of fees. *See* Proposing Release, *supra* footnote 2 at 1294. Any modifications that would need to be made to conform to a streamlined set of conditions from existing exemptive orders would be minor relative to the adjustments that would need to be made to comply with the redemption limit under the Proposal.

[13] The Commission cites the omission of participation agreement requirements as a cost savings for funds who currently rely on exemptive orders. As of the date of this letter, Fidelity has participation agreements in place with over eighty different fund companies that allow the PAS Funds to exceed the statutory limits on fund investments in reliance on its exemptive order. The Fidelity funds also serve as acquired funds for other fund companies and have executed participation agreements under other funds' exemptive orders. In our experience, the process of entering into and monitoring compliance with the participation agreements – as both acquired and acquiring funds – is neither onerous nor costly, and the removal of this requirement will afford Fidelity no meaningful cost savings. Further, as discussed in section IV.B.4 below, the participation agreement affords funds the ability to obtain the information necessary to identify, restrict and/or monitor transactions between or involving affiliates under the 1940 Act.

[14] *See* Proposing Release, *supra* footnote 2 at 1332 ("This alternative [approach of codifying the conditions in existing exemptive orders] would not limit an acquiring fund's ability to quickly redeem or tender a large volume of acquired fund shares to mitigate undue influence, which could impose liquidity constraints and restrict funds' investment flexibility.").

[15] *See, e.g.,* Schwab Capital Trust, et al., Investment Company Act Release No. 24067 (Oct. 1, 1999) (Notice); ING Partners, Inc., et al., Investment Company Act Release No. 27116 (Oct. 12, 2005) (Notice); Frank Russell Investment Company, et al., Investment Company Act Release No. 27288 (Apr. 17, 2006) (Notice); Fidelity Rutland, *supra* footnote 11; Pacific Life Insurance Company, et al., Investment Company Act Release No. 29944 (Feb. 13, 2012) (Notice); Janus Investment Fund, et al., Investment Company Act Release No. 31753 (Aug. 13, 2015) (Notice). We also note that to the extent that any consideration is paid by the unaffiliated acquired fund to an acquiring fund or certain of its service providers and their affiliates, the board of the acquired fund must make certain determinations that the consideration is fair and reasonable, and that it does not involve overreaching on the part of any person concerned. *See, e.g.,* Fidelity Rutland, *supra* footnote 11 (Condition 4).

conditions in existing exemptive orders to prevent the abuses that Section 12(d)(1) seeks to curtail.

B. Allow Funds to Either Operate Under their Existing Exemptive Orders or Comply with the Proposed Rule

Similar to other recipients of exemptive relief for fund of funds arrangements, Fidelity has adapted its business and operated its fund of funds structures in reliance on these orders for over two decades.[16] If the Commission does not codify the conditions in its funds of funds exemptive orders and instead adopts materially different conditions as proposed, we strongly urge the Commission not to rescind existing funds of funds exemptive orders in the absence of any evidence that the fund's existing conditions are insufficient to protect against the harms that Section 12(d)(1) seeks to protect. The SEC took a similar approach when it adopted exemptive Rules 12d1-1, 12d1-2 and 12d1-3 in 2006 and codified and expanded on its prior exemptive orders.[17] There, the SEC recognized that a "fund might conclude that continued reliance on an existing order is appropriate, for example, because the existing order was tailored to circumstances specific to a fund complex and may provide additional exemptive relief that is not covered under the [newly adopted exemptive rules]."[18] This approach would afford new entrants the benefit of relying on the Proposal without incurring the costs of seeking exemptive relief, while allowing existing funds of funds to avoid the unnecessary and costly restructuring of their businesses to comply with a new set of conditions. The SEC could continue to evaluate the operation of funds of funds in the industry under the new rule alongside funds of funds that are relying on existing exemptive orders without taking the drastic step of rescinding all exemptive orders.[19]

Should the SEC not extend this relief to all existing funds of funds exemptive orders, we believe that at a minimum, the SEC should allow funds of funds that are captive to an affiliated managed account program to maintain their existing exemptive orders. These types of captive

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[16] Fidelity Rutland, *supra* footnote 11; Colchester Street Trust, et al., Investment Company Act Release Nos. 24337 (Mar. 13, 2000) (notice) and 22171 (Apr. 10, 2000) (order) ("Colchester Street") (amends Daily Money Fund, et al., Investment Company Act Release Nos. 22107 (July 29, 1996) (notice) and 22171 (Aug. 26, 1996) (order)).

[17] *See* Fund of Funds Investments, Investment Company Act Release No. 27399 (June 20, 2006) ("Fund of Funds Adopting Release").

[18] *See id.* at n. 115.

[19] Before adopting any final rule, the Commission should clarify that any rescission of outstanding exemptive orders relates only to the portions of such orders that provide Section 12 relief. Applicants have often consolidated other requested relief with funds of funds relief for administrative convenience and efficiency. Were these outstanding orders to be rescinded in their entirety, it could create challenges for funds that currently utilize non-Section 12(d)(1) relief contained in fund of funds orders to run their operations. In order to maintain efficient operations and minimize the impact any final rule would have on shareholders, funds should be permitted to continue to rely on the non-Section 12 relief contained in these exemptive orders. *See, e.g.,* Colchester Street, *supra* footnote 16 (providing additional relief from §17(a) of the 1940 Act to conduct in-kind purchases of shares of underlying Fidelity funds provided such acquisition complies with the requirements of Rule 17a-7 under the 1940 Act); Fidelity Commonwealth Trust, et al., Investment Company Act Release Nos. 32166 (Jun 29, 2016) (notice) and 32191 (Jul 26, 2016) (order) (providing additional relief from §§2(a)(32), 5(a)(1), 22(d) and 22(e) of the 1940 Act and Rule 22c-1, in part, to permit the operation of an ETF inside a master-feeder structure and to allow for self-indexing).

funds of funds are simply conduits that advisers use to deliver a broad range of investment strategies more efficiently and achieve a more consistent allocation of investment strategies across these accounts. They are not funds that are available for sale to the general public. Using these fund of funds arrangements in this context also simplifies underlying fund holdings for clients by distilling in their prospectuses the principal investment strategies and risks of potentially hundreds of underlying funds that may otherwise be held directly in the managed accounts. In this case, funds of funds minimize, rather than increase, complexity and investor confusion.

Funds of funds that are captive to an affiliated managed account program also do not give rise to the policy concerns underlying Section 12(d)(1) regarding complex structures or duplicative fees and are no more likely to exert undue influence over underlying funds than any other large, institutional investor. Unlike other funds of funds, it is the account's adviser, and not the individual program client, who makes the decision to purchase a fund of funds in a discretionary managed account program. In these programs, the adviser to the managed accounts also serves (or has an affiliate that serves) as the adviser to the funds of funds that are captive to the program, and as such fully appreciates the complexity of its fund of funds structures as well as the fees, exposure and risks of the underlying investments.[20] For the PAS Funds, Strategic currently waives or credits back all fees payable to Strategic or its affiliates by the funds of funds or any underlying fund as a result of an investment by any PAS account, regardless of whether the account consists of retirement or taxable assets. In other cases, managed account sponsors may credit back to a retirement account any fees paid to it or its affiliates in connection with the purchase of affiliated funds of funds in the account as a way to address transactions that may be prohibited under the U.S. tax code or ERISA.[21] The Commission's concerns over excessive advisory fees for these products are also addressed through the SEC's required disclosures of acquired fund fees and expenses in the funds' prospectuses, which were implemented in 2006 to put investors on notice of the indirect costs attributable to investments in underlying funds.[22]

In addition, funds of funds that are captive to managed account programs are not capable of influencing an underlying fund to any greater extent or in a manner different than any other

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[20] We note that our ability to create complex fund of funds structures for PAS is also limited by the PAS Funds' exemptive order, which prohibits any acquired fund from itself exceeding the Section 12(d)(1)(A) limits, save for certain limited exceptions (e.g., short-term cash management purposes, in connection with interfund lending or borrowing transactions, or receipt of fund shares as a dividend or as a result of a plan of reorganization). *See* Fidelity Rutland, *supra* footnote 11.

[21] Retirement account fee crediting may be done in order to avoid violations of statutory prohibited transactions, *see, e.g.*, DOL Adv. Op. 1997-15A (Frost Bank); DOL Adv. Op. 2005-10A (Country Trust Bank), or may be done to qualify for an exemption to the prohibited transaction rules (*see* DOL PTE 77-4).

[22] *See* Fund of Funds Investments, Investment Company Act Release No. 26198 (Oct. 1, 2003) ("[W]e would address the concerns regarding excessive advisory fees through the proposed amendments to Forms N-1A and N-2 requiring disclosure of acquired fund expenses."). Boards of management companies are also required under the issued exemptive orders to make certain findings that shareholders are not paying duplicative advisory fees for the same services. *See* Proposing Release, *supra* footnote 2 at 1318 ("For management companies, our exemptive orders …require the acquiring fund board to find that advisory fees are based on services provided that are in addition to, rather than duplicative of, the services provided by an adviser to an acquired fund.").

large, institutional investor, such as investment banks or sponsors to defined benefit or contribution plans. As previously noted, any managed account program can be structured, as Fidelity's PAS program was originally designed, such that all underlying funds are held directly by client accounts instead of through collective vehicles such as funds of funds. In this non-fund of funds structure, the program adviser could achieve the same overall exposure to the underlying funds but potentially exert even more influence on the underlying funds.[23] A proposed rule that does not take these differences into account puts managed account programs on an unlevel playing field. Indeed, any disparate treatment that threatens the investment flexibility of these types of fund of funds arrangements may result in their restructuring or elimination, and potentially undermines the value and efficiency they bring to managed account programs. The preservation of their exemptive orders or availing these funds of an exemption from the redemption limit, as more fully described below, avoids this result.

IV. MODIFICATIONS TO THE PROPOSED RULE

In the event that the Commission proceeds with the framework of Rule 12d1-4 as proposed, we strongly urge it to eliminate the redemption limit as a condition of the proposed rule because it would be ineffective, may impede advisers' abilities to fulfill their fiduciary obligations to funds and their shareholders, may negatively impact a fund's liquidity, and may impact how funds of funds are managed and structured. If the Commission retains the proposed redemption limit, we request that it exempt redemptions that do not raise the risk of harm that Section 12(d)(1) seeks to address, including in-kind redemptions, fund of funds arrangements involving affiliated funds, and affiliated managed account programs. Finally, we request that the Commission consider creating an alternative to the redemption limit, namely for redemptions that are conducted pursuant to the terms of a negotiated participation agreement between acquiring and acquired funds.

A. The Proposed Redemption Limit Should be Eliminated

The Commission's proposed rule contains a limitation on redemptions that is aimed to address regulatory concerns that acquiring funds may exercise undue influence over other funds by threatening to engage in large-scale redemptions of the acquired funds' shares.[24] We strongly oppose the imposition of any redemption limit because it is unnecessary and presents potential challenges from both an investment management and liquidity standpoint.[25] The redemption

[23] For example, managed accounts are not subject to Section 12 limits on how much they can invest in other registered investment companies and as such, their advisers can potentially wield more influence over such funds than a fund of funds ever could.

[24] Proposing Release, *supra* footnote 2 at 1298.

[25] Although the SEC requests feedback on whether it should adopt a higher or lower limit on redemptions than 3% (or a different time period over which it should apply the redemption limit), we do not believe that a redemption limit set at any level and imposed over any time period would achieve the Commission's objective. In order to ensure that advisers can fulfill their fiduciary obligations to shareholders, any redemption limit must have exclusions for the numerous, legitimate instances where large-scale redemptions are warranted, exclusions which would inevitably swallow the rule. Based on our review of historical redemptions in the last three years, the largest

limit also presents administrative challenges of tracking outstanding voting securities of numerous third-party funds to maintain compliance, information which is not readily available to the investing public.[26] The Proposing Release provides no explanation and cites no recent enforcement action that supports the notion that the conditions under the existing exemptive orders have failed to protect against undue influence, nor are we aware – based on our experience managing both acquiring and acquired funds – of any prevalent market practice of using such threats to coerce underlying funds. None of the existing exemptive orders issued by the Commission contains such a restriction and no justification is provided for why this additional protection is necessary.[27] For the following reasons, we believe the Commission should reconsider the imposition of a redemption limit as a condition of the proposed rule, and rely on the proposed control limitations and voting provisions as well as the fiduciary obligations imposed on advisers by federal and state law to effectively mitigate the risks of undue influence.[28]

1. *Redemption Limits are Ineffective to Protect Against the Threat of Undue Influence*

We believe that a redemption limit fails to meet the Commission's intended goal of protecting against the threat of undue influence. The power to unduly influence an underlying fund is grounded not in the speed of a redemption, but rather in the prospective loss of assets and consequently, management fee revenue that follows.[29] This power is neither isolated nor is it any greater in the hands of funds of funds, because any large institutional investor has the potential to unduly influence an underlying fund through the threat of redemption.

redemption over a rolling 30-day period in an unaffiliated fund was 19.2% of the underlying fund's net assets, and, in an affiliated fund, was 77% of the underlying fund's net assets. *See infra* section IV.A.2.

[26] Information on outstanding voting securities is typically available monthly and obtained from third party sources such as Bloomberg. Assuming that we did have timely information on an unaffiliated acquired fund's outstanding voting securities, the Commission would also need to provide clear guidance on how to calculate the total percentage redeemed over multiple transactions, particularly because outstanding voting securities can fluctuate meaningfully on a daily basis.

[27] We recognize that in 2008, the Commission proposed redemption limits applicable to investments of more than 3% of an ETF, which was largely supported by commenters. *See* Exchange-Traded Funds, Investment Company Act Release No. 28193 (Mar. 11, 2008). However, ETFs only accept redemptions from authorized participants, typically large broker-dealers, and such a restriction would not impact most acquiring funds who transact in ETF shares on the secondary market.

[28] *See, e.g.*, § 36(a) of the 1940 Act, which would authorize the SEC to seek injunctive or other relief for acts "constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company", including acts involving some form of self-dealing by an adviser.

[29] *See, e.g.*, Letter from Barclays Global Fund Advisors, Inc. to SEC (May 16, 2008), at p. 22, n. 68, *available at* https://www.sec.gov/comments/s7-07-08/s70708-14.pdf ("[Barclays Global Fund Advisors, Inc.] has never experienced an investor (of any kind) seeking to control or unduly influence an ETF. Moreover, given that many existing ETFs frequently experience large scale redemptions in response to normal market activity, it is difficult to see how an investor could effectively extract a concession (such as brokerage business) from an ETF by threatening such redemptions.").

The Commission states that the threat of large-scale redemptions is two-fold: these redemptions (i) have the potential to "disrupt portfolio management or increase transaction fees if fund managers must hold cash or sell portfolio securities at an inopportune time to meet redemptions", and (ii) "may be threatening to a fund manager because they decrease the fund's assets under management, on which the manager's fee is based."[30] The proposed redemption limit attempts to address the former concern, but not the latter, given that it delays but does nothing to stop an impending redemption. The SEC's emphasis on the quickness of a large-scale redemption overestimates the magnitude of its impact; it is difficult to conceive how the sudden impact of a large redemption to a fund's portfolio in and of itself would be so significant to induce an improper concession from that fund.[31] First, the potential impact of a large redemption by an unaffiliated acquiring fund is capped; the control limitations in the proposed rule and the issued exemptive orders effectively limit the impact of such a redemption to no more than 25% of the acquired fund.[32] Second, when faced with substantial redemption requests by investors (e.g., retirement plan changes), portfolio managers have a variety of tools to accommodate these requests. Funds typically reserve the right to pay redemption proceeds in readily marketable securities instead of cash for this very occasion. This allows for transfers at current market values, does not impact asset prices and may minimize or eliminate fund transaction costs of liquidating portfolio assets. Fidelity is very experienced in managing large redemptions in this fashion to meet the requests of its investors, while minimizing the impact to remaining shareholders. Finally, although mutual funds normally process redemption requests by the next business day, funds can delay payment of proceeds for up to seven days if making immediate payment would adversely affect the fund.[33]

2. *Redemption Limits May Conflict with an Adviser's Fiduciary Obligations and Certain Provisions of the 1940 Act*

We are concerned that the imposition of the proposed redemption condition may also limit portfolio management flexibility, which in turn may impede an adviser's ability to fulfill its fiduciary obligations to funds. Contrary to the Commission's expectation "that the impact of the redemption limit on funds' investment flexibility would be small," our analysis of redemption activity over the course of several years demonstrates that large redemptions routinely play an important role in how we manage our funds.[34] From 2016 to 2018, Fidelity estimates that the PAS Funds redeemed more than 3% of an acquired fund's total outstanding shares in a rolling 30-day period a total of 149 times, which was during a period of relatively low market volatility

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[30] *See* Fund of Funds Adopting Release, *supra* footnote 17.

[31] Importantly, securities do not need to be sold every time a fund receives a redemption order. Sales of fund assets are necessary only when redemptions significantly exceed inflows.

[32] As discussed in section IV.B.1, although investments by affiliated fund of funds are not capped under current exemptive relief, an adviser would be prevented from seeking to unduly influence an affiliated acquired fund given its (or its affiliate's) fiduciary obligation to both the acquiring and acquired funds.

[33] Investment Company Act § 22(e), 15 U.S.C. § 80a-22(e). As a practical matter, two-day settlement requirements under Exchange Act Rule 15c6-1, 17 C.F.R. § 240.15c6-1 (imposing maximum time period on broker dealers for the payment of funds and delivery of securities), effectively take most fund investments to a T+2 settlement timeline.

[34] Proposing Release, *supra* footnote 2, at 1320.

and positive flows for the PAS program.[35] In the same period, the GAA Funds are estimated to have redeemed more than 3% of an affiliated fund's total outstanding shares in a rolling 30-day period a total of 172 times.[36]

Fidelity's fund-of-funds products, similar to other funds of funds, may engage in large-scale redemptions for many beneficial reasons including portfolio rebalancing, satisfaction of redemption requests by shareholders, migration of assets in response to market conditions or material changes to an underlying fund (e.g., portfolio manager or principal investment strategy changes), and redemptions in anticipation of underlying fund liquidations or in conjunction with the liquidation or merger of a fund of funds itself. Funds of funds also may engage in large-scale redemptions of underlying funds to fund new sub-advisers of the fund of funds[37] or new affiliated underlying funds that are dedicated to the managed account program.[38] The proposed restraint on redemption flexibility would not only impede the foregoing, but would also render a fund of funds' manager incapable of quickly exiting an investment when there is a loss of confidence in the performance of the underlying portfolio manager or, in the most severe cases, of fraud, bankruptcy, or other liquidity concerns about the underlying fund or its adviser. In these cases, all other investors would be able to redeem their entire investments promptly, leaving funds of funds and their shareholders stranded in the investment, thereby exposing them to greater investment risk and bearing the underlying fund's transaction costs of liquidating portfolio assets for other investors.[39]

In addition, the redemption limitations appear to run counter to the restrictions contained in Sections 18(f) and 22(e) of the 1940 Act.[40] With respect to their interest in underlying funds, fund of funds products often acquire shares that result in their investment being comingled with

[35] Approximately one third of the 149 redemptions were out of unaffiliated acquired funds (non-ETFs). 116 of the 149 redemptions were in cash, and in 33 cases the redemptions were in kind. All data excludes secondary market sales of ETFs.

[36] One hundred fifty-one of these redemptions were in cash, and 21 of these redemptions were in kind. All redemptions were out of affiliated mutual funds.

[37] A PAS Fund may transition a fund position into a sub-advised sleeve by hiring the underlying fund's adviser (or an entirely new adviser) to manage a sleeve of the PAS Fund directly. In this case, the fund would liquidate the fund position to fund the new sub-adviser's sleeve of the portfolio. The vast majority of transitions from a fund position to a sub-advised sleeve managed by the same adviser are processed in kind.

[38] To date, Fidelity has launched 19 dedicated funds that are available for use solely by Strategic in its management of the PAS Funds or PAS accounts. In many cases, Strategic initially funded the dedicated funds with redemption proceeds (typically a combination of cash and securities) from Fidelity retail funds.

[39] The SEC itself estimates that under the proposed redemption limits, a 25% position in an acquired fund "would take the acquiring fund 10 months to fully unwind … assuming no concurrent changes in the number of acquired fund shares that are unrelated to the acquiring fund's redemptions." *See* Proposing Release, *supra* footnote 2 at 1325. Therefore, an investment in an affiliated acquired fund, for which there is no limit, could potentially take years to liquidate.

[40] *See* §18(f) of the 1940 Act (prohibiting registered open-end investment companies from issuing senior securities); §22(e) of the 1940 Act (generally restricting registered investment companies from suspending the right of redemption more than seven days).

other non-fund shareholders in one or more of the acquired fund's share classes.[41] In our experience, it is not uncommon for our funds of funds to stand alongside other institutional, intermediary and even retail shareholders in a particular class of an unaffiliated acquired fund.

Were the proposed redemption limit adopted, it would put funds of funds on unequal footing with other holders of the same class of shares of an acquired fund. For example, assume a fund of funds held 10% of the outstanding shares of Fund X, while at the same time an institutional separate account held 15% of the outstanding shares of the same fund. In the event of some major event (be it Fund X specific or the market in general), the fund of funds would be required to stage its redemption activity over an approximate four-month period, while the larger institutional account position could be entirely redeemed in a single day. Putting aside the negative effect this aspect of the proposed rule could have on fund of funds arrangements generally, its mandate could be viewed as placing a senior security in the hands of any non-fund of funds shareholder in the same class of shares who is not subject to the rule.[42] Although the SEC Staff could grant relief in this regard or require registered investment companies to address these inequities within the construct of an 18f-3 plan, forcing funds to do so would appear to be inconsistent with the overall policy considerations underlying Section 18(f) of the 1940 Act.

Similarly, the redemption limitations contained in the Proposal would appear inconsistent with the provisions of Section 22(e) of the 1940 Act.[43] Under that Section, the redemption rights that attach to shares of open-end registered investment companies can be suspended only in limited prescribed circumstances. More specifically, a fund may suspend redemptions for any period during which (i) the New York Stock Exchange is closed (other than customary weekend and holiday closings) or is trading on a restricted basis, or (ii) an emergency exists as a result of which disposal by the fund of its portfolio securities is not reasonably practicable or it is not reasonably practicable for such fund to fairly determine the value of its net assets (collectively, "Market-Driven Events").[44] Redemption rights can also be suspended for such other periods as the Commission, by order, permit for the protection of security holders of the registered investment company ("Fund-Specific Events").[45] In addition, Rule 2a-7 provides an exemption from Section 22(e) to allow non-government money market funds to temporarily suspend redemptions in the event that a fund's weekly liquid assets drop below 30%; however, the "temporary suspension of redemptions must apply to all shares."[46]

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[41] Within the context of affiliated products, fund sponsors can effectively segregate fund of funds assets through the utilization of single-class "dedicated" underlying funds, which isolate fund of funds assets (and their activity) from other types of shareholders. Under the proposed rule such a structure would avoid §18(f) concerns. To the extent a fund of funds product utilizes unaffiliated funds, it lacks the ability to control for this issue through the use of dedicated funds.

[42] Or when looked at from the fund of fund's point of view, would result in acquisition of a subordinate security.

[43] *See* §22(e) of the 1940 Act (generally prohibiting registered investment companies from suspending the right of redemption or postponing payment upon redemption for more than seven days after the tender of such security).

[44] It should be noted that, under both scenarios, it rests with the Commission to determine, by rules and regulations, when these standards are met. *See* §22(e) of the 1940 Act.

[45] *See* §22(e)(3) of the 1940 Act.

[46] *See* Rule 2a-7(c)(2)(i).

The redemption restrictions contained in the Proposal could be viewed as inconsistent with Section 22(e) as they are not the result of any Market-Driven Event. Further, to the extent the Staff intends to view the restrictions as a response to a Fund-Specific Event, it would be imposing the restriction on only a subset of the fund's shareholders. Similar to the concerns raised above, segregating and restricting the interests of funds from those of identically situated investors would appear to be inconsistent with the overall policy considerations underlying both Section 22(e) and the 1940 Act more generally.[47]

3. *Redemption Limits May Negatively Impact the Liquidity of Funds of Funds*

We are also concerned that the proposed redemption limit could negatively impact the liquidity of funds of funds.[48] Unlike the SEC's proposed redemption limit for ETFs in 2008, funds of funds have no alternative recourse to liquidate their mutual fund shares under the Proposal.[49] In the event that funds of funds experience large-scale redemptions by their own shareholders, such as during periods of market stress, they may have difficulty satisfying these requests under the rule as proposed, particularly since a redemption in kind to thousands of individual fund of funds shareholders is impracticable.

There are also potential issues reconciling the proposed redemption limit with the SEC's mandate that funds hold no more than 15 percent of their assets in illiquid securities.[50] Although the proposed control limitation caps fund investments to 25% of an unaffiliated acquired fund, there are no limits on how much that investment can represent as a portion of the acquiring fund's assets. Certain of our funds invest in an affiliated fund that represents upwards of 64% of the acquiring fund's assets, and 24% in the case of an unaffiliated acquired fund.[51] To the extent that an acquiring fund exhausted its 3% redemption limit with an acquired fund, the balance of its position in that fund would be rendered illiquid and the acquiring fund may find itself in violation of the SEC's illiquid securities limitation without any corrective options to promptly dispose of the position.

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[47] Proponents of the Proposal could argue that its application does not directly implicate §22(e) because it simply gates the submission of redemption orders and does not, in and of itself, alter the characteristics of the security held by a fund of funds shareholder. Although such an argument might alleviate §22(e) concerns, it could raise others (*e.g.*, §48(a)).

[48] As of February 28, 2019, 77% of the total net assets of Fidelity's multi-asset class products hold a greater than 3% position in an affiliated acquired fund (excluding ETFs) and as such, would be subject to the redemption limitations under the proposed rule. Approximately 81% of the assets in the fund of funds sleeves of the PAS Funds, or roughly 39% of their total net assets, are in greater than 3% positions in acquired funds (excluding ETFs). Unaffiliated funds comprise approximately 38% of the greater than 3% non-ETF fund positions by net assets in the PAS Funds.

[49] *See* Fund of Funds Adopting Release, *supra* footnote 17.

[50] Arguably, the consideration for large scale redemptions should already be part of an acquired fund's liquidity risk management program, which further negates the need for a separate redemption limitation.

[51] *See e.g.*, Monthly Holdings Reports of Fidelity Freedom Index 2060 Fund (holding Fidelity Total Market Index Fund, 63.75% of its net assets as of Jan. 31, 2019) and Strategic Advisers Short Duration Fund (holding PIMCO Short-Term Fund, 24.402% of its net assets as of Jan. 31, 2019).

4. *Redemption Limits May Impact How Funds of Funds are Managed and Structured*

We do not believe that the potential for undue influence outweighs the substantial impact that a redemption restriction would have on funds of funds and the fund industry generally, particularly in the absence of any evidence of widespread abuse. Contrary to the Commission's belief that the proposed redemption limit would not have a large effect on funds, we believe that an adviser's flexibility to redeem is a key management tool and the proposed limitation on this flexibility may impact how these funds are managed and structured.[52] In order to preserve this flexibility, funds of funds will likely migrate out of smaller funds and into larger funds to dilute their position and/or favor ETFs where feasible. The expense ratios of the funds from which these funds of funds would redeem may also increase, raising costs for other acquired fund shareholders.[53] In addition, Fidelity has created numerous dedicated funds for use by the PAS Funds and the PAS program, which avoids the impact that large or frequent purchases and redemptions may otherwise have on retail shareholders. However, limits on redemption capabilities may incentivize the PAS Funds to migrate back into retail funds. This potential preference for larger funds also may deprive small and mid-size fund families of a significant flow of assets and may result in their disfavor by funds of funds.

Additionally, certain funds of funds may seek to avoid the redemption limit by converting into "manager of managers" funds or relying more heavily on this structure by engaging the acquired funds' advisers directly as sub-advisers in lieu of holding fund positions.[54] Engaging an underlying fund manager directly rather than through a fund investment entails costs related to screening, due diligence, and ongoing monitoring and oversight. This transition would also increase the oversight responsibilities and workload of the funds' boards. For our PAS Funds, we estimate that if we hired all the advisers of the funds with whom we have a participation agreement to manage sleeves of our funds directly, this would result in more than triple the number of sub-advisers that are currently overseen by the PAS Funds' board (i.e., from 30 to over 100 sub-advisers).[55]

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[52] *See* Proposing Release, *supra* footnote 2 at 1299 ("Based on the staff's analysis of redemptions of acquired fund shares, we do not believe that our proposed redemption limit would have a large effect on funds.").

[53] As assets decline, the expense ratios of funds may rise, depending on their expense structure.

[54] To the extent that funds of funds pursue this structure, the SEC is likely to see an increase in requests for so-called "manager of managers" exemptive relief to enable these advisers to enter into new or amended sub-advisory agreements with sub-advisers without obtaining shareholder approval of such agreements. The PAS Funds are a hybrid in that they are both funds of funds and managers of managers funds; they rely on two forms of exemptive relief to exceed the Section 12(d)(1) limits in underlying funds and also have the ability to engage new unaffiliated sub-advisers with board approval alone. *See* Fidelity Rutland, *supra* footnote 11 and *In re* Fidelity Management & Research Company et al., Investment Company Act Release Nos. 27544 (Nov. 2, 2006) (Notice) and 27585 (Nov. 28, 2006) (order).

[55] An increase in the number of sub-advisers of this magnitude would significantly impact Fidelity's sub-adviser oversight program and would likely necessitate additional resources to support the costs of ongoing due diligence and review of the sub-advisers in the program.

In addition to the foregoing options, funds of funds that are captive to a managed account program may shift underlying fund positions out of the funds of funds and have them directly held in the managed accounts to avoid the proscriptions of Section 12(d)(1) entirely and consequently, the need to rely on exemptive relief. In this case, managed account clients could potentially receive hundreds of shareholder communications as opposed to the handful that they currently receive today. Given this potential volume, these managed account clients would have difficulty deciphering the overall exposure and principal risks of the funds in their managed accounts, which are currently succinctly summarized in the prospectuses of their funds of funds.[56] Shareholders of acquired funds may also bear an increase in expenses related to shareholder communications and proxies that were once directed to funds of funds but may now be delivered directly to potentially hundreds of thousands of managed account clients.

B. Proposed Carve-Outs and Alternatives to the Redemption Limit

As detailed above, we strongly recommend that the SEC eliminate the proposed redemption limit entirely. If the Commission proceeds with the adoption of a redemption limit, we urge it to exempt fund of funds arrangements involving affiliated funds and affiliated managed account programs from such limitations given that they do not give rise to the risk of undue influence that Section 12(d)(1) aims to address. We also request that the SEC create an exception to the redemption limit for redemptions in kind, which minimize the potential adverse effects that large-scale redemptions can have on an underlying fund. Finally, as a further alternative, we propose that the SEC permit an acquiring fund to either abide by the redemption limit or enter into a participation agreement that is similar to what is currently required under existing exemptive orders.

1. *Affiliated Funds*

To the extent that the Commission proceeds with the proposed redemption limit, we believe it should not apply to affiliated funds, because funds in the same group of investment companies (as defined in Section 12(d)(1)(G)(ii)) are not subject to the threat of coercive behavior. For example, affiliated funds may share the same adviser or an affiliated adviser, who has a fiduciary obligation to act in the best interests of both acquiring and acquired funds.[57] As the Commission notes in the Proposing Release, "in cases where the arrangement involves funds that are advised by advisers that are control affiliates, we do not believe that the acquiring fund adviser generally would seek to benefit the acquiring fund at the expense of the acquired fund (nor do we believe that the acquiring fund would seek to influence the acquired fund through its ownership interest in the acquired fund)."[58] In any event, we do not see how affiliated funds are susceptible to the harm of large scale redemptions under one form of exemptive relief, but not under the statutory exception; the risk of undue influence for funds by their affiliates is no

[56] We estimate that for at least one of the investment preferences in the PAS program, the direct holdings of a PAS client in mutual funds and ETFs would increase from 17 to 126 if the underlying funds were migrated out of fund of funds and into direct positions of the accounts.

[57] *See* Proposing Release, *supra* footnote 2 at 1297. ("In circumstances where the acquiring fund and 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.").

[58] *See* Proposing Release, *supra* footnote 2 at 1297.

greater under Rule 12d1-4 than it is under Section 12(d)(1)(G), which lacks any similar limitations on redemptions.

2. *Fund of Funds Captive to Managed Account Programs*

Funds of funds that are captive to an affiliated managed account program should also be excluded from any redemption limit, because as previously noted, they do not raise the policy concerns that Section 12(d) is designed to address; such funds are simply one component of a larger service offering and serve as conduits through which managed account clients access a broad range of investment strategies in a more efficient manner. From a control perspective, there is no functional difference between those managed account programs that access mutual funds through funds of funds, versus those that do not utilize this structure. Discretionary advisers to managed accounts that do not use fund of funds arrangements can exert the same, if not more, influence over underlying funds and are not subject to any of the constraints of Section 12(d)(1)(A). Disparate treatment of managed account programs may also result in their restructuring to preserve maximum investment flexibility, as detailed above.

3. *In-Kind Redemptions*

The Commission should create an exception to the redemption limit for redemptions that are satisfied with securities in lieu of cash (i.e., in-kind redemptions) because these redemptions do not implicate the harms to acquired funds that large scale cash redemptions can present. These redemptions minimize disruptions to the acquired fund's operations and performance, do not require the adviser to liquidate the fund's assets at an inopportune time, and isolate the costs of liquidating securities to satisfy the redemption request to the redeeming shareholder. The creation of an exception would not deprive acquired funds of the protection of the redemption limit under the rule. Because the satisfaction of large redemptions in kind is typically at a fund's discretion, acquired funds would continue to have the option of declining any redemption request by an acquiring fund when it exceeded the redemption limit under the proposed rule. We note, however, that although an exception for in-kind redemptions would be helpful, it alone would not ameliorate all of the burdens that arise from the redemption limit as described above.[59]

4. *Allow an Acquiring Fund to Either Comply with the Redemption Limit Condition or Enter into a Participation Agreement with the Acquired Fund*

If the Commission retains a redemption limit in the final rule, we recommend that the rule be updated to permit an acquiring fund to either abide by the limit or, alternatively, enter into a participation agreement with an unaffiliated acquired fund prior to any investment in excess of the Section 12(d)(1)(A)(i) limits.

As previously noted, Fidelity has numerous participation agreements in place involving Fidelity funds – both as acquiring or acquired funds – and believes that negotiating, implementing and monitoring compliance with this type of agreement will not be overly

[59] For instance, certain securities such as those from select emerging market countries or complex derivatives may not be eligible for an in-kind redemption to be held directly by the redeeming fund due to regulatory and/or operational constraints.

burdensome for either party. Participation agreements would enable acquired funds to negotiate lower investment limits for acquiring funds than otherwise permitted under exemptive relief and/or reserve the right to fulfill redemption requests in kind.[60] The SEC could also require that the agreement includes representations that the acquiring fund will not cause any existing or potential investment to influence the terms of any services or transactions between the funds and their affiliates, or an unaffiliated acquired fund to purchase a security in an affiliated underwriting.[61] To further mitigate the risk of undue influence, the Commission could condition the use of participation agreements on required board findings and procedures relating to affiliated underwritings and payments made by an unaffiliated acquired fund (or certain of its affiliates) to prevent overreaching and undue influence, which are currently required under existing exemptive orders.[62] Nevertheless, how an acquired fund chooses to be protected from undue influence under the rule would rest with the acquired fund; it could always avail itself of the protection of the redemption limit under the rule by refusing to enter into the participation agreement.

Participation agreements can also provide a means for funds to identify their "affiliated persons" and to restrict and/or monitor transactions between such funds and such affiliates in accordance with the 1940 Act (*e.g.,* Sections 10(f) and 17(e)(1)).[63] When an acquiring fund obtains exemptive relief from the Commission to purchase shares of unaffiliated funds in excess of the statutory limits, it is often the case that the acquiring fund, in reliance on a fund of funds exemptive order, acquires a position in excess of five percent of the unaffiliated fund's outstanding shares. This renders the two funds affiliates of each other, subjecting them both to applicable affiliated transactions prohibitions and restrictions of the 1940 Act. Unlike in the affiliated fund of funds context, unaffiliated funds of funds rarely have access to the information that would be required to adequately restrict, monitor and/or report these transactions.[64]

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[60] In our experience, it is not uncommon for acquired funds to request provisions in our participation agreements that cap our funds' investments to a lower threshold than what would otherwise be permitted under our exemptive order.

[61] *See, e.g.,* Fidelity Rutland, *supra* footnote 11 (Conditions 2 and 5). The SEC could also require that the participation agreement contain an acknowledgment that the receipt of certain compensation for the purchase or sale of acquired fund shares may be prohibited by Section 17(e)(1) of the 1940 Act. *See id.* at note 7.

[62] *See* Proposing Release, *supra* footnote 2 at 1299 (summarizing the board findings and procedures required under existing fund of funds exemptive orders).

[63] *See* §10(f) of the 1940 Act and Rule 10f-3 thereunder (restricting registered investment companies from acquiring securities during the existence of an underwriting or selling syndicate); §17(e) (prohibiting certain compensation arrangements between affiliates).

[64] The inclusion of affiliated fund of funds offerings within a fund complex rarely raises any increased difficulty in this regard given the adviser's complete access to the information required to monitor and report these transactions. Similarly, acquisition of funds that are not part of the same group of investment companies as the acquiring fund generally fail to raise concerns because the applicable statutory limitations fall below the level that would be required to establish affiliation through shareholder status alone. *See* §12(d)(1)(A)(i) (limiting acquisition of underlying funds to three percent of such fund's outstanding voting stock); §12(d)(1)(F) (providing for limited relief from §12(d)(1)(A)(ii) & (iii) to the extent the acquiring fund and all of its affiliates own not more than three percent of outstanding stock of the underlying fund). Absent some other basis for affiliation, a fund becomes "affiliated" with another fund to the extent it owns, controls or holds with the power to vote, five percent or more of the outstanding voting securities of the unaffiliated fund.

Presumably, the Commission is aware of these concerns when it grants exemptive relief as most fund of funds orders impose an information-sharing regime and further require acknowledgements regarding certain affiliated transaction prohibitions.[65]

As a result of these required conditions and acknowledgements, fund-of-funds exemptive orders have successfully established a line of communication between acquiring funds and unaffiliated acquired funds, allowing for the flow of information critical to ensuring that all parties understand the web of affiliations and restrictions to which they will be subject.[66] Under the Proposal, that avenue will no longer exist, although participation agreements could be used to fill this gap. Moreover, as discussed in section VI.B. below, participation agreements can serve as a means to comply with the rule's complex structures condition by including a representation that the acquired fund will not rely on the rule for the duration of the agreement.[67]

V. RECONSIDER RESCINDING RULE 12d1-2

The SEC should not rescind Rule 12d1-2 and related exemptive orders and staff no-action letters, which provide funds of funds that invest in affiliated funds in reliance on Section 12(d)(1)(G) the flexibility to invest in unaffiliated funds, securities, money market funds, and other instruments, such as futures contracts (collectively, "Other Investments"). Fidelity's affiliated funds of funds have relied for years on this relief to invest in Other Investments through both Rule 12d1-2 and Fidelity's own exemptive relief. The SEC has not explained why it is rescinding this flexibility, which provides benefits to over 100 of our funds of funds and their shareholders.

The ability to invest directly in Other Investments allows our funds of funds greater flexibility to seek to meet their investment objectives than is possible by investing solely in other investment companies. For example, a fund of funds may seek to "equitize" inflows of cash received late in the day by investing in futures contracts on a broad stock index as opposed to leaving the cash uninvested overnight, allowing the fund to be fully invested in accordance with

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[65] *See, e.g.,* Fidelity Rutland, *supra* footnote 11 (among other conditions, requiring the exchange of acquiring fund affiliate lists, the adoption of procedures regarding participation in affiliated underwritings, and the execution of negotiated participation agreements). Section IV.D of the Fidelity application requires an acknowledgement that the receipt of compensation by: (a) an affiliated person of an acquiring fund, or an affiliated person of such person, for the purchase by the acquiring fund of shares of an underlying fund, or (b) an affiliated person of an underlying fund, or an affiliated person of such person, for the sale by the underlying fund of its shares to the acquiring fund may be prohibited by Section 17(e)(1) of the 1940 Act. The application further requires that the participation agreement include this acknowledgement.

[66] In addition to the requirement that an acquiring fund share its list of certain affiliates with underlying funds at such time as its investment exceeds the §12(d)(1)(A)(i) limits, fund of funds exemptive orders obligate acquiring funds to deliver updates to such lists "as soon as reasonably practicable after a change occurs." *See, e.g.,* Fidelity Rutland, *supra* footnote 11 (Condition 8).

[67] If participation agreements are not available as an option in lieu of the redemption limit, prior to adopting any final rule, the Commission should consider maintaining some form of required communication between the parties to a fund of funds arrangement (either through maintaining the regime currently contained in numerous fund of funds orders or by creating some new equivalent regime) to ensure the parties have access to information vital to their ability to accurately monitor for compliance with the various affiliated transactions restrictions contained in the 1940 Act.

its investment strategies and potentially improving the fund's performance. The use of Other Investments can provide benefits beyond equitizing cash; a fund of funds can avoid impacting an acquired fund with short-term purchase and redemption activity by maintaining holdings in highly liquid securities such as futures and ETFs to net shareholder flows at the acquiring fund level. In addition, there may be times when using a derivative may allow a fund to invest in eligible asset classes with greater efficiency and at a lower cost than is possible through investment in an acquired fund. Alternatively, a fund may determine that the use of a futures contract in conjunction with the fund's investment in acquired funds would permit the fund to pursue its investment objective more effectively than is possible solely through investments in securities of open-end investment companies. A fund may also determine that it is more efficient and cost-effective to gain exposure to an asset class or strategy by using a sub-adviser for a portion of its assets, in combination with investments in acquired funds.

We believe that our ability to use a fund of funds structure in combination with direct investments in Other Investments allows us to create more diversified, flexible investment products for our investors. The Commission itself noted in the adopting release for Rule 12d1-2 that permitting an affiliated fund of funds to invest, consistent with the fund's investment policies, directly in securities "would allow an acquiring fund greater flexibility in meeting investment objectives that may not be met as well by investments in other funds in the same fund group, while not presenting any additional concerns that Section 12(d)(1)(G) was intended to address."[68] In the Proposing Release, the Commission has not presented any compelling justification for reversing this position and now requiring an affiliated fund of funds to comply with the conditions of the Proposed Rule, which are much more restrictive than the conditions of Rule 12d1-2 or related exemptive orders and no-action letters, if it wishes to retain the flexibility to invest directly in Other Investments. We believe that the Commission should retain Rule 12d1-2 and should codify the ability to invest in other instruments, such as futures contracts, that currently exists in exemptive orders and no-action letters.

VI. RECONSIDER COMPLEX FUND STRUCTURES AND ITS PROPOSED REGISTRATION STATEMENT DISCLOSURE

A. Limits on Multi-Tier Fund of Funds Structures

Proposed Rule 12d1-4 contains conditions designed to restrict fund of funds arrangements to two tiers, subject to certain limited exceptions discussed in the proposed rule.[69] The Commission notes in the Proposing Release that these conditions are designed to prevent the creation of complex structures that could cause investor confusion or result in duplicative and excessive fees.[70]

Fidelity believes that certain types of multi-tier fund of funds arrangements are beneficial to investors, without increasing the risks of investor confusion or fee duplication. For many

[68] *See* Fund of Funds Adopting Release, *supra* footnote 17, at 36644.

[69] *See* Proposed Rule 12d1-4(b)((4).

[70] *See* Proposing Release, *supra* footnote 2 at 1306.

years, Fidelity has utilized multi-tier fund of funds structures in its product offerings. In these cases, a funds of funds may invest in an underlying fund that, in turn, invests its assets in one or more dedicated "central funds," which typically invest in securities of an asset class, market sector or industry, thus creating a three-tier fund of funds structure. The funds investing in another fund at each tier of the structure do so pursuant to an SEC exemptive order granted to Fidelity or an SEC rule.[71] These central funds, which are unavailable for purchase by the general public, do not separately charge management fees, sales loads, redemption fees or distribution/Rule 12b-1 fees.

Based on our experience, the use of central funds in a multi-tier structure has enabled Fidelity to more effectively manage sub-portfolios for Fidelity mutual funds. The key benefits of these central funds to our mutual funds include:

- more efficient pooled investment management and trading because pooling the funds' assets allows for netting of cash flows across the funds and reduces the number of transactions necessary for allocations, thus reducing transaction costs;
- for smaller sub-portfolios, providing better diversification by taking advantage of the larger asset base in a central fund;
- eliminating the distractions and complexities of multiple clone accounts increases the capacity of portfolio managers and traders, allowing investment professionals to focus on security selection and portfolio management; and
- providing a central source for other Fidelity funds seeking a specific type of investment exposure that a central fund may offer.

Fidelity recommends that the SEC continue to permit multi-tier structures that utilize dedicated funds, similar to Fidelity's central funds, in which the dedicated funds are part of the same group of investment companies as the top-level funds and so long as the dedicated funds do not charge management fees, sales loads, redemption fees or distribution/Rule 12b-1 fees. We believe that the creation of a multi-tier structure under these circumstances can assist fund sponsors to more efficiently manage and trade fund assets without raising the Congressional concerns that underlie Section 12(d)(1).

B. Narrow the Disclosure Requirement for the Complex Structures Condition

Proposed Rule 12d1-4 would require a fund that relies on the proposed rule (or wants to preserve investment flexibility to rely on the rule) to disclose in its registration statement that it is (or may be) an acquiring fund for purposes of the proposed rule.[72]

Fidelity believes that the proposed disclosure requirement in the complex structures condition is unworkable. First, the disclosure requirement places the onus on the acquiring fund to monitor an acquired fund's registration statement to determine whether the fund relies on, or is preserving the flexibility to rely on, Rule 12d1-4. Fidelity is concerned that there may be lags between when an acquired fund decides to rely on the proposed rule and become an acquiring fund and when it updates its registration statement, causing violations of the rule if an acquiring

[71] *See supra* footnote 26.

[72] *See* Proposed Rule 12d1-4(b)(4)(i); Proposing Release, *supra* footnote 2 at 1307.

fund purchases the acquired fund in the intervening period between when it decides to become an acquiring fund and when it updates its registration statement.

In addition, Fidelity believes that the proposed disclosure requirement may incentivize funds to disclose in their registration statements that they may be an acquiring fund for purposes of the rule, even though they do not have any current intention to invest in an acquired fund. Funds may adopt this approach to preserve future flexibility to invest in other funds; a fund that becomes an acquired fund would find it difficult to unwind a fund of funds structure to enable it to invest in other funds (beyond the limited exceptions contained in proposed Rule 12d1-4(b)(4)(iii)) and it therefore would be prohibited from investing in other funds above the Section 12(d)(1)(A) limits. Because funds would want to preserve this flexibility, the disclosure requirement could significantly reduce the number of funds willing to become acquired funds and narrow the universe of investment opportunities for funds of funds.

Fidelity believes that there are better approaches to addressing the Commission's concerns with complex structures as compared to proposed Rule 12d1-4's disclosure requirements. Under one approach, a fund relying on Section 12(d)(1)(G) or proposed Rule 12d1-4 to invest in other funds would be prohibited from acquiring shares of another fund in excess of the limits contained in Section 12(d)(1)(A) if the other fund discloses as a principal investment strategy in its prospectus that it may invest in other funds. As an alternative approach, to the extent that the Commission permits the use of participation agreements in fund of funds arrangements, an acquiring fund could rely on a representation by an acquired fund that the acquired fund will not rely on Rule 12d1-4 to invest in another fund above the Section 12(d)(1)(A)(i) limits. In either case, we believe that these alternatives accomplish the SEC's goals of avoiding complex investment structures, either by prohibiting a fund from acquiring shares of a *bona fide* acquiring fund (i.e., a fund that has as its principal investment strategy a policy to invest in other funds) or by requiring an acquired fund to represent in an agreement that it would not become an acquiring fund. In short, we believe these alternatives accomplish the SEC's goals, without requiring constant monitoring by an acquiring fund, and potential gaps which could lead to inadvertent violations.

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Fidelity would be pleased to provide further information, participate in any direct outreach efforts the Commission undertakes, or respond to questions the Commission may have about our comments.

Sincerely,

Jonathan Chiel

cc: The Honorable Jay Clayton, Chairman
The Honorable Robert J. Jackson Jr., Commissioner
The Honorable Hester M. Peirce, Commissioner
The Honorable Elad L. Roisman, Commissioner

Dalia Blass, Director, Division of Investment Management