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INVESTMENT COMPANY INSTITUTE
Washington, DC // Brussels // London // www.ici.org

Redemption Restrictions in the SEC's Proposed Fund of Funds Rule Would Harm Retirement Savers

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ICI Provides Recommendations to Streamline Regulatory Framework While Avoiding Disruption for Investors

Washington, DC; May 1, 2019—A Securities and Exchange Commission (SEC) rule proposal governing funds of funds could ultimately harm investors saving for important financial goals if not modified, according to a comment letter filed by the Investment Company Institute (ICI). The Institute's letter commends the SEC for working to simplify the regulatory framework governing these funds but offers recommendations to prevent undue harm to millions of savers from specific aspects of the proposal, including redemption limits.

In a fund of funds arrangement, one fund buys and holds shares of other funds. ICI recently surveyed its members about the proposal, and 50 complexes with more than 1,300 fund of funds arrangements and $2.8 trillion in assets responded. Nearly 70 percent of these funds with $2.0 trillion in assets would be affected by the new rule.

"The SEC's proposed rule takes an important step toward streamlining the confusing regulatory patchwork governing funds of funds, but more work is needed to arrive at a final rule that will not cause undue disruption, and harm retirement savers," said ICI President and CEO Paul Schott Stevens. "Our greatest concern focuses on the proposed redemption restrictions that would prevent fund managers from acting in the best interest of investors and could result in financial harm to shareholders, if included in the final rule."

ICI's letter generally supports the other aspects of the SEC's proposed rule and offers suggestions to address the:

- Voting of shares (pages 16–19)
- Evaluation of fees and corresponding recommendations (pages 19–20)
- Use of multitier arrangements (pages 20–23)
- Scope of the rule (pages 23–24)
- Revisions of existing orders, guidance, and relief (pages 26–28)
- Ability of private funds to unduly influence closed-end funds (pages 29–31)

Redemption Restrictions Would Hurt Investors and Their Retirement Savings

The SEC's proposed rule would restrict funds of funds that invest more than 3 percent in another fund's outstanding shares from redeeming more than 3 percent of the fund's total outstanding shares in any 30-day period. In its comments, ICI explains that these restrictions could harm funds of funds and their shareholders—including target date funds (TDFs), which are commonly structured as funds of funds and have grown in popularity among retirement savers.

For example, if a fund is underperforming, it may not make sense for a TDF to hold that fund. The redemption limits, however, could hinder the TDF from quickly replacing that underlying fund with a more appropriate one. This would prevent the fund manager from acting in investors' best interests and could cause, and exacerbate, financial harm to savers.

The letter also shows how the restrictions would put funds of funds and their shareholders at a severe disadvantage compared to other investors. For example, a TDF would be restricted from selling shares of an underperforming fund while other investors in that

fund would be able to redeem their shares (pages 10–13).

Proposed Limits Are Inconsistent with Current Fund of Funds Regulation

The SEC proposed redemption limits, in part, to ensure that a fund cannot influence an underlying fund by threatening to redeem a large number of shares. ICI explains, however, that the current regulation governing funds of funds successfully addresses this concern. For example, Congress and the SEC allow funds to invest in funds within the same investment company family and in different fund families, without imposing redemption restrictions, because legislators and the Commission:

- acknowledge that an investment adviser has fiduciary obligations to both funds in an affiliated fund of funds arrangement, and those duties mitigate the risk of one fund exerting control over an underlying fund by threatening substantial redemptions; and
- require funds and boards to put procedures in place to prevent a fund from inappropriately influencing an underlying fund in a different fund family.

ICI contends that the SEC's proposal does not give any evidence that the current rationales and regulations have failed to address its concerns about preventing undue influence (pages 7–10).

In addition, ICI notes that the Commission's proposed approach seems to ignore funds' responsibilities and obligations under the new liquidity risk management rule (pages 11–13).

The SEC Should Remove Proposed Redemption Limits

To ensure that funds of funds can continue to successfully benefit investors, ICI strongly urges the SEC to remove the proposed redemption restrictions. The Commission acknowledges that funds of funds in the same family do not raise concerns about undue influence. As a result, ICI maintains that funds investing in the same group of funds should not be subject to the redemption restrictions.

Funds investing in funds that are not part of the same family could use participation agreements if a fund wants to invest more than 3 percent in another fund, explains ICI. The letter details how these agreements have successfully served funds of funds over the past 20 years and notes that they are an accepted part of hundreds of existing exemptive orders. Using these tested and familiar agreements would be consistent with current practices and would help achieve the Commission's goal of streamlining fund of funds regulation (pages 13–16).

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