



# Federal Register

---

**Tuesday,  
June 27, 2006**

---

**Part III**

## **Securities and Exchange Commission**

---

**17 CFR Parts 239, 270, and 274  
Fund of Funds Investments; Final Rule**

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Parts 239, 270, and 274

[Release Nos. 33-8713; IC-27399; File No. S7-18-03]

RIN 3235-AI30

### Fund of Funds Investments

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule.

**SUMMARY:** The Securities and Exchange Commission (“Commission”) is adopting three new rules under the Investment Company Act of 1940 that address the ability of an investment company (“fund”) to acquire shares of another fund. Section 12(d)(1) of the Act prohibits, subject to certain exceptions, so-called “fund of funds” arrangements, in which one fund invests in the shares of another. The rules broaden the ability of a fund to invest in shares of another fund in a manner consistent with the public interest and the protection of investors. The Commission also is adopting amendments to forms used by funds to register under the Investment Company Act and offer their shares under the Securities Act of 1933. The amendments improve the transparency of the expenses of funds by requiring that the expenses of the acquired funds be aggregated and shown as an additional expense in the fee table of the fund of funds.

**DATES:** *Effective Date:* July 31, 2006.

*Compliance Dates:* All new registration statements on Forms N-1A, N-2, N-3, N-4, or N-6, and all post-effective amendments that are annual updates to effective registration statements on Forms N-1A, N-2, N-3, N-4, or N-6 filed on or after January 2, 2007, must include the disclosure required by the amendments.

#### FOR FURTHER INFORMATION CONTACT:

Dalia Osman Blass, Attorney, or Penelope W. Saltzman, Branch Chief, Office of Regulatory Policy, (202) 551-6792, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549.

**SUPPLEMENTARY INFORMATION:** The Commission today is adopting new rules 12d1-1, 12d1-2 and 12d1-3 under the Investment Company Act of 1940 (the “Investment Company Act” or the “Act”) that address the ability of an investment company (“fund” or “acquiring fund”) registered under the Act to invest in shares of another investment company (“fund” or

“acquired fund”).<sup>1</sup> We also are adopting amendments to Forms N-1A, N-2, N-3, N-4, and N-6 to require that prospectuses of funds of funds disclose the expenses investors in the acquiring fund will bear, including those of any acquired funds.<sup>2</sup> Forms N-1A and N-2 are the registration forms used by open-end management funds and closed-end management funds, respectively, to register under the Act and to offer their shares under the Securities Act of 1933 (“Securities Act”).<sup>3</sup> Forms N-3, N-4 and N-6 are the forms used by insurance company separate accounts to register under the Act and to offer their variable annuity and variable life insurance contracts under the Securities Act.

#### Table of Contents

I. Background
II. Discussion
A. Rule 12d1-1: Investments in Money Market Funds
1. Scope of Exemption
2. Conditions
B. Rule 12d1-2: Affiliated Funds of Funds
1. Investments in Unaffiliated Funds
2. Investments in Other Types of Issuers
3. Investments in Money Market Funds
C. Rule 12d1-3: Unaffiliated Funds of Funds
D. Amendments to Disclosure Forms: Transparency of Fund of Funds Expenses
III. Paperwork Reduction Act
IV. Cost-Benefit Analysis
V. Consideration of Promotion of Efficiency, Competition, and Capital Formation
VI. Final Regulatory Flexibility Analysis
VII. Statutory Authority
Text of Rules and Form Amendments

#### I. Background

The Federal securities laws restrict substantially the ability of a fund to invest in shares of other funds. These restrictions are designed to prevent fund of funds arrangements that have been used in the past to enable investors in an acquiring fund to control the assets of an acquired fund and use those assets

<sup>1</sup>The Investment Company Act is codified at 15 U.S.C. 80a. The new rules will be found in the Code of Federal Regulations at 17 CFR 270.12d1-1, 17 CFR 270.12d1-2, and 17 CFR 270.12d1-3, respectively. For convenience, any reference we make in this release to rules 12d1-1, 12d1-2 or 12d1-3, or any paragraph of the rules, will be to those sections of the Code of Federal Regulations.

<sup>2</sup>Rules requiring use of these forms under both the Investment Company Act and the Securities Act of 1933 may be found in the Code of Federal Regulations at: 17 CFR 239.15A, 17 CFR 274.11A (Form N-1A); 17 CFR 239.14, 17 CFR 274.11a-1 (Form N-2); 17 CFR 239.17a, 17 CFR 274.11b (Form N-3); 17 CFR 239.17b, 17 CFR 274.11c (Form N-4); and 17 CFR 239.17c, 17 CFR 274.11d (Form N-6).

<sup>3</sup>The Securities Act is codified at 15 U.S.C. 77a. The terms “open-end management funds” and “closed-end management funds” are defined in 15 U.S.C. 80a-5(a)(1) and (2), respectively.

to enrich themselves at the expense of acquired fund shareholders.<sup>4</sup> Under section 12(d)(1) of the Act, funds are subject to certain prohibitions relating to fund of funds investments. Section 12(d)(1)(A) prohibits a registered fund (and companies or funds it controls) from—

- Acquiring more than three percent of a fund’s outstanding voting securities;
- Investing more than five percent of its total assets in any one acquired fund;

or

- Investing more than ten percent of its total assets in all acquired funds.<sup>5</sup>

Section 12(d)(1)(B) prohibits a registered open-end fund from selling securities to any fund (including unregistered funds) if, after the sale, the acquiring fund would—

- Together with companies and funds it controls, own more than three percent of the acquired fund’s voting securities;

- Together with other funds (and companies they control) own more than ten percent of the acquired fund’s voting securities.<sup>6</sup>

Although these two provisions of section 12(d)(1) have proven quite effective in putting a stop to the abusive practices that characterized previous fund of funds arrangements, Congress has recognized that they also had the effect of preventing legitimate fund of funds arrangements. To prevent this, Congress created three statutory exceptions.<sup>7</sup> Our rulemaking today relates to two of those exceptions:

*Unaffiliated Fund of Funds Arrangements.* Section 12(d)(1)(F) permits a registered fund to take small positions in an unlimited number of other funds (an “unaffiliated fund of

<sup>4</sup>For a discussion of these “pyramiding” schemes and the additional problems fund of funds arrangements can create for shareholders, see Fund of Funds Investments, Investment Company Act Release No. 26198 (Oct. 1, 2003) [68 FR 58226 (Oct. 8, 2003)] (“Proposing Release”). See also U.S. Securities and Exchange Commission, Investment Trusts and Investment Companies, H.R. Doc No. 279, 76th Cong., 1st Sess., pt. 3, at 2721-95 (1939).

<sup>5</sup>See 15 U.S.C. 80a-12(d)(1)(A). If the acquiring fund is not registered under the Act, the prohibitions apply only with respect to its acquisition of securities in funds that are registered under the Act. Funds (together with companies or funds they control and funds that have the same adviser) also are limited to acquiring no more than 10 percent of the outstanding voting stock of a closed-end fund. 15 U.S.C. 80a-12(d)(1)(C).

<sup>6</sup>See 15 U.S.C. 80a-12(d)(1)(B). By limiting the sale of registered fund shares to other funds, section 12(d)(1)(B) prevents the creation of a fund of registered funds regardless of the limitations of U.S. law to regulate the activities of foreign funds. For a discussion of the events that led to the adoption of sections 12(d)(1)(A) and 12(d)(1)(B) of the Act, see Proposing Release, *supra* note 4, at nn. 7-13 and accompanying text.

<sup>7</sup>See sections 15 U.S.C. 80a-12(d)(1)(E), 15 U.S.C. 80a-12(d)(1)(F), and 15 U.S.C. 80a-12(d)(1)(G).

funds"). A fund taking advantage of the exception provided in section 12(d)(1)(F) of the Act (and its affiliated persons) may acquire no more than three percent of another fund's outstanding stock;<sup>8</sup> cannot charge a sales load greater than 1½ percent;<sup>9</sup> and is restricted in its ability to redeem shares of the acquired fund.<sup>10</sup> In addition, the fund's adviser would not be able to influence the outcome of shareholder votes in the acquired fund.<sup>11</sup>

**Affiliated Fund of Funds Arrangements.** Section 12(d)(1)(G) permits a registered open-end fund or unit investment trust ("UIT")<sup>12</sup> to acquire an unlimited amount of shares of other registered open-end funds and UITs that are part of the same "group of investment companies," (typically known as a fund complex).<sup>13</sup> A fund taking advantage of this exception (an "affiliated fund of funds") is restricted in the types of other securities it can hold in addition to shares of registered funds in the same group of investment companies.<sup>14</sup> The acquired funds must have a policy against investing in shares of other funds in reliance on section 12(d)(1)(F) or 12(d)(1)(G) (to prevent multi-tiered structures),<sup>15</sup> and overall distribution expenses are limited (to prevent excessive sales loads).<sup>16</sup> Relying

on this provision, several large fund complexes include a fund of funds, which allocates and periodically reallocates its assets among funds in the complex.<sup>17</sup>

## II. Discussion

Since 1940 we have provided limited relief for funds to acquire shares of other funds when the proposed arrangements did not present the risk of abuses that section 12(d)(1) was designed to prevent. We issued those orders under our general exemptive authority in section 6(c) of the Act.<sup>18</sup> In 1996, when Congress added section 12(d)(1)(G), it also gave us specific authority to exempt any person, security or transaction, or any class or classes of transactions, from section 12(d)(1) of the Act if the exemption is consistent with the public interest and the protection of investors.<sup>19</sup>

In October 2003, we proposed three new rules to address the ability of a registered fund to invest in shares of another fund without first having to seek Commission approval.<sup>20</sup> The rules were proposed to codify and expand upon a number of exemptive orders we

acquired fund, or (ii) the aggregate sales loads or distribution-related fees charged by the acquiring fund on its securities and paid by the acquiring fund on acquired fund securities are not excessive under rules adopted under section 22(b) [15 U.S.C. 80a-22(b)] or 22(c) [15 U.S.C. 80a-22(c)] by a securities association registered under section 15A of the Securities Exchange Act of 1934 (the "Exchange Act") [15 U.S.C. 78o-3] or the Commission. The NASD has adopted limits on sales loads and distribution-related fees applicable to funds as well as to funds of funds. See NASD Rule 2830(d)(3) ("NASD Sales Charge Rule").

Under the NASD Sales Charge Rule for funds of funds, if neither the acquiring nor acquired fund has an asset-based sales charge (12b-1 fee), the maximum aggregate sales load that can be charged on sales of acquiring fund and acquired fund shares cannot exceed 8.5 percent. See NASD Sales Charge Rule 2830(d)(3)(A). Any acquiring or acquired fund that has an asset-based sales charge must individually comply with the sales charge limitations on funds with an asset-based sales charge, provided, among other conditions, that if both funds have an asset-based sales charge, the maximum aggregate asset-based sales charge cannot exceed .75 of 1 percent per year of the average annual net assets of both funds; and the maximum aggregate sales load may not exceed 7.25 percent of the amount invested, or 6.25 percent if either fund pays a service fee. See NASD Sales Charge Rule 2830(d)(3)(B). The rule is designed so that cumulative charges for sales-related expenses, no matter how they are imposed, are subject to equivalent limitations. See Order Approving Proposed Rule Change Relating to the Limitation of Asset-Based Sales Charges as Imposed by Investment Companies, Exchange Act Release No. 30897 (July 7, 1992) [57 FR 30985 (July 13, 1992)], at text accompanying n. 9.

<sup>17</sup> See, e.g., T. Rowe Price Retirement Funds, Prospectus 1-10 (Oct. 1, 2005).

<sup>18</sup> 15 U.S.C. 80a-6(c).

<sup>19</sup> National Securities Markets Improvement Act of 1996, Pub. L. 104-290, § 202, 110 Stat. 3416, 3427 (1996) (codified at 15 U.S.C. 80a-12(d)(1)(j)).

<sup>20</sup> Proposing Release, *supra* note 4.

have issued that permit funds to invest in other funds.<sup>21</sup> We also proposed amendments to Forms N-1A, N-2, N-3, N-4, and N-6 to require funds of funds to disclose acquired fund expenses in their prospectuses. We received five comments on the proposal.<sup>22</sup> Commenters supported the proposed rules and amendments, but suggested changes. Today, we are adopting rules 12d1-1, 12d1-2 and 12d1-3, and amendments to Forms N-1A, N-2, N-3, N-4, and N-6 substantially as proposed, with changes that respond to issues raised by commenters.

### A. Rule 12d1-1: Investments in Money Market Funds

Rule 12d1-1 allows funds to invest in shares of money market funds in excess of the limits of section 12(d)(1). The rule is designed to permit "cash sweep" arrangements in which a fund invests all or a portion of its available cash in a money market fund rather than directly in short-term instruments. Commenters agreed with our assessment that fund investments in money market funds, which did not exist in 1940, do not raise the concerns that underlie section 12(d)(1).<sup>23</sup> Some, however, persuaded us to make some modifications to the rule, which we describe below.<sup>24</sup>

<sup>21</sup> See *id.*, at nn. 36, 72 and 87.

<sup>22</sup> See Comment Letter of Fidelity Management & Research Company ("FMR") (Dec. 19, 2003); Comment Letter of the Investment Company Institute ("ICI") (Dec. 3, 2003); Comment Letter of IMRC Group (Nov. 18, 2003); Comment Letter of Man Investments, Inc. (Dec. 1, 2003); Comment Letter of Joel Torrance (June 17, 2004). The comment letters are available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549 (File No. S7-18-03). The comment letters are also available on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed/s71803.shtml>).

<sup>23</sup> See Comment Letter of IMRC Group (Nov. 18, 2003); Comment Letter of ICI (Dec. 3, 2003). For a more extensive discussion of this analysis, see Proposing Release, *supra* note 4, at nn. 38-39 and accompanying text.

<sup>24</sup> One commenter recommended amending rule 17d-1 to permit joint transactions that would allow funds to take advantage of other cash management tools, such as joint repurchase agreements where the fund participates on terms not different from those applicable to its affiliated participant. See Comment Letter of ICI (Dec. 3, 2003). The broader relief suggested is outside the scope of our proposals. We are, however, adopting a technical amendment to rule 12d1-1 in response to this commenter's assertion that the proposed defined term "Administrative Fees" could create confusion because the term is used elsewhere in our rules. See, e.g., 17 CFR 270.11a-3 and Instruction 3 to Item 3 of Form N-1A. We have eliminated the term and defined the fees subject to the rule in the applicable provision without any substantive changes to the provision. See rule 12d1-1(b)(1).

<sup>8</sup> See 15 U.S.C. 80a-12(d)(1)(F)(i).

<sup>9</sup> See 15 U.S.C. 80a-12(d)(1)(F)(ii).

<sup>10</sup> A fund whose shares are acquired pursuant to section 12(d)(1)(F) is not obligated to redeem more than 1 percent of its total outstanding securities during any period of less than 30 days. 15 U.S.C. 80a-12(d)(1)(F).

<sup>11</sup> Section 12(d)(1)(F), by reference to section 12(d)(1)(E) of the Act, requires the acquiring fund to vote shares of an acquired fund either by seeking instructions from the acquiring fund's shareholders, or to vote the shares in the same proportion as the vote of all other shareholders of the acquired fund. See 15 U.S.C. 80a-12(d)(1)(E)(iii)(aa).

<sup>12</sup> The Act defines "unit investment trust" as a fund that: (i) Is organized under a trust indenture, contract of custodianship or agency, or similar instrument; (ii) does not have a board of directors; and (iii) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities, but does not include a voting trust. 15 U.S.C. 80a-4(2).

<sup>13</sup> 15 U.S.C. 80a-12(d)(1)(G). For purposes of the exception, the term "group of investment companies" means "any 2 or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services." 15 U.S.C. 80a-12(d)(1)(G)(ii).

<sup>14</sup> In addition to investing in securities of registered funds in the same group of investment companies, the Act permits these funds to invest only in government securities and short-term paper. See 15 U.S.C. 80a-12(d)(1)(G)(i)(II).

<sup>15</sup> See 15 U.S.C. 80a-12(d)(1)(G)(i)(IV).

<sup>16</sup> See 15 U.S.C. 80a-12(d)(1)(G)(i)(III). The provision permits a fund to invest in shares of another fund only if either (i) the acquiring fund does not charge a sales load or distribution-related fee or does not pay (and is not assessed) sales loads or distribution-related fees on securities of the

## 1. Scope of Exemption

### (a) Registered Money Market Funds

Rule 12d1-1 permits a fund to invest an unlimited amount of its uninvested cash in a money market fund rather than directly in short-term instruments.<sup>25</sup> Any investment would, of course, have to be consistent with the fund's investment objectives and policies.<sup>26</sup> The acquired fund may be a fund in the same fund complex or in a different fund complex. Thus, a fund in a small complex that does not have a money market fund may invest available cash in an unaffiliated money market fund.

In addition to providing an exemption from section 12(d)(1) of the Act, the rule provides exemptions from section 17(a) and rule 17d-1, which restrict a fund's ability to enter into transactions and joint arrangements with affiliated persons.<sup>27</sup> These provisions would otherwise prohibit an acquiring fund from investing in a money market fund in the same fund complex,<sup>28</sup> or prohibit

<sup>25</sup> Rule 12d1-1(a). Our exemptive orders had limited cash sweep investments to 25 percent of the acquiring fund's total assets. *See, e.g.,* Vanguard Group, Inc., *et al.*, Investment Company Act Release Nos. 26406 (Mar. 29, 2004) [69 FR 17460 (Apr. 2, 2004)] (notice) and 26436 (Apr. 23, 2004) (order); Putnam American Government Income Fund, *et al.*, Investment Company Act Release Nos. 26200 (Oct. 1, 2003) [68 FR 57937 (Oct. 7, 2003)] (notice) and 26414 (Apr. 9, 2004) (order) ("Putnam Order"); Credit Suisse Asset Management, LLC, *et al.*, Investment Company Act Release Nos. 25789 (Oct. 29, 2002) [67 FR 67220 (Nov. 4, 2002)] (notice) and 25832 (Nov. 22, 2002) (order).

<sup>26</sup> *See infra* note 49.

<sup>27</sup> Section 17(a) generally prohibits affiliated persons of a registered fund ("first-tier affiliates") or affiliated persons of the fund's affiliated persons ("second-tier affiliates") from selling securities or other property to the fund (or any company the fund controls). 15 U.S.C. 80a-17(a). Section 17(d) of the Act makes it unlawful for first- and second-tier affiliates, the fund's principal underwriters, and affiliated persons of the fund's principal underwriters, acting as principal, to effect any transaction in which the fund, or a company it controls, is a joint or a joint and several participant in contravention of Commission rules. 15 U.S.C. 80a-17(d). Rule 17d-1(a) prohibits first- and second-tier affiliates of a registered fund, the fund's principal underwriters, and affiliated persons of the fund's principal underwriter, acting as principal, from participating in or effecting any transaction in connection with any joint enterprise or other joint arrangement or profit-sharing plan in which the fund (or any company it controls) is a participant unless an application regarding the enterprise, arrangement or plan has been filed with the Commission and has been granted. 17 CFR 270.17d-1.

<sup>28</sup> An affiliated person of a fund includes any person directly or indirectly controlling, controlled by, or under common control with such other person. *See* 15 U.S.C. 80a-2(a)(3)(C) (definition of "affiliated person"). Most funds today are organized by an investment adviser that advises or provides administrative services to other funds in the same complex. Funds in a fund complex are generally under common control of an investment adviser or other person exercising a controlling influence over the management or policies of the funds. *See* 15 U.S.C. 80a-2(a)(9). Not all advisers control funds

a fund that acquires five percent or more of the securities of a money market fund in another fund complex from making any additional investments in the money market fund.<sup>29</sup>

Commenters agreed with us that an acquiring fund's purchase and redemption of money market fund shares at net asset value would provide little opportunity for the insider self-dealing or overreaching that section 17 was designed to prevent.<sup>30</sup> They agreed that these exemptions would benefit funds and their shareholders, supporting our conclusion that these provisions are appropriate and in the public interest.<sup>31</sup>

One commenter expressed concern, however, that without additional relief from section 17, acquiring funds might not be able to take full advantage of the proposed exemption.<sup>32</sup> If a fund in one fund complex acquired more than five percent of the assets of a money market fund in another fund complex, any broker-dealer affiliated with that money market fund would become a (second-tier) affiliated person of the acquiring fund.<sup>33</sup> As a result of the affiliation, the broker-dealer's fee for effecting the sale of securities to the acquiring fund would be subject to the conditions set forth in rule 17e-1, including the quarterly board review and recordkeeping requirements with respect to certain securities transactions

they advise. The determination of whether a fund is under the control of its adviser, officers, or directors depends on all the relevant facts and circumstances. *See* Investment Company Mergers, Investment Company Act Release No. 25259 (Nov. 8, 2001) [66 FR 57602 (Nov. 15, 2001)], at n. 11. For purposes of this release, we presume that funds in a fund complex are under common control because funds that are not affiliated persons would not require, and thus not rely on, the exemptions from section 17(a) and rule 17d-1.

<sup>29</sup> An affiliated person of a fund also includes: (i) Any person directly or indirectly owning, controlling, or holding with power to vote, five percent or more of the outstanding voting securities of the fund; and (ii) any person five percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote by the fund. *See* 15 U.S.C. 80a-2(a)(3)(A), (B). Thus, a fund that acquires five percent of the securities of another fund would be affiliated with that fund and any transactions with the fund would be subject to the limitations of section 17. *See supra* note 27.

<sup>30</sup> *See* Comment Letter of IMRC Group (Nov. 18, 2003).

<sup>31</sup> *See* Comment Letter of ICI (Dec. 3, 2003); Comment Letter of FMR (Dec. 19, 2003).

<sup>32</sup> *See* Comment Letter of IMRC Group (Nov. 18, 2003). Although the commenter requested additional relief from section 17 of the Act, the commenter did not specify any sections or rules other than section 17(e) and rule 17e-1 thereunder. The additional section 17 relief we are providing is limited to certain provisions of rule 17e-1 under the Act.

<sup>33</sup> *See supra* note 29.

involving the affiliated broker-dealer.<sup>34</sup> We believe that it is unlikely that a broker-dealer would be in a position to take advantage of a fund merely because that fund owned a position in a money market fund affiliated with the broker-dealer.<sup>35</sup> Accordingly, the final rule permits an acquiring fund to pay commissions, fees, or other remuneration to a (second-tier) affiliated broker-dealer without complying with the quarterly board review and recordkeeping requirements set forth in rules 17e-1(b)(3) and 17e-1(d)(2).<sup>36</sup> This relief is available only if the broker-dealer and the acquiring fund become affiliated solely because of the acquiring fund's investment in the money market fund. We believe this additional relief will enable more funds to take advantage of the exemption provided by the rule.

### (b) Unregistered Money Market Funds

Rule 12d1-1 also permits funds to invest in money market funds that are not registered investment companies

<sup>34</sup> Section 17(e)(2) of the Act prohibits an affiliated person (or second-tier affiliate) of a fund from receiving compensation for acting as a broker, in connection with the sale of securities to or by the fund if the compensation exceeds limits prescribed by the section unless permitted by rule 17e-1 under the Act. 15 U.S.C. 80a-17(e)(2). Rule 17e-1 sets forth the conditions under which a commission, fee or other remuneration shall be deemed as not exceeding the "usual and customary broker's commission" for purposes of section 17(e)(2)(A) of the Act. Rule 17e-1(b)(3) requires the fund's board of directors, including a majority of the directors who are not interested persons under section 2(a)(19) of the Act, to determine at least quarterly that all transactions effected in reliance on the rule have complied with procedures which are reasonably designed to provide that the brokerage compensation is consistent with the rule's standards. Rule 17e-1(d)(2) specifies the records that must be maintained by each fund with respect to any transaction effected pursuant to rule 17e-1.

<sup>35</sup> The money market fund's adviser would have no influence over the decisions made by the acquiring fund's adviser. In addition, because the interests of the adviser to the money market fund and the adviser to the acquiring fund are directly aligned with their respective funds, transactions between the acquiring fund and a broker-dealer affiliate of the money market fund are likely to be at arm's length.

<sup>36</sup> Rule 12d1-1(c). This exemption also is available for payments to broker-dealer affiliates of unregistered money market funds. *See infra* notes 37-42 and accompanying text. The relief provided by this exemption is similar to relief provided in a number of exemptive orders issued by the Commission. *See, e.g.,* SunAmerica Series Trust, *et al.*, Investment Company Act Release Nos. 21203 (July 14, 1995) [60 FR 37485 (July 20, 1995)] (notice) and 21276 (Aug. 9, 1995) (order); Prudential Investments LLC, *et al.*, Investment Company Act Release Nos. 25736 (Sept. 18, 2002) [67 FR 59869 (Sept. 24, 2002)] (notice) and 25771 (Oct. 16, 2002) (order). An acquiring fund relying on this exemption is required to comply with all of the provisions of rule 17e-1, except 17e-1(b)(3) and (d)(2). We do not believe that having to comply with the other provisions contained in rule 17e-1 would deter acquiring funds from taking full advantage of the exemption provided by the rule.

(“unregistered money market funds”). Unregistered money market funds are typically organized by a fund adviser for the purpose of managing the cash of other funds in a fund complex and operate in almost all respects as a registered money market fund, except that their securities are privately offered and thus not registered under the Securities Act.<sup>37</sup> Although a fund’s investments in unregistered money market funds are not restricted by section 12(d)(1), these investments are subject to the affiliate transaction restrictions in the Act and rules thereunder and thus require exemptions from section 17(a) and rule 17d-1.<sup>38</sup>

Commenters had no specific comments on this provision of the proposal, and we have adopted it substantially as proposed.<sup>39</sup> The exemption is available only for investments in an unregistered money market fund that operates like a money market fund registered under the Act. To be eligible, an unregistered money market fund is required to (i) limit its investments to those in which a money market fund may invest under rule 2a-7 under the Act,<sup>40</sup> and (ii) undertake to comply with all the other provisions of rule 2a-7.<sup>41</sup> In addition, the unregistered money market fund’s adviser must be registered as an investment adviser with the Commission.<sup>42</sup> Finally, the acquiring fund is required to reasonably believe that the unregistered money market fund operates like a registered money market fund and that it complies with certain provisions of the Act.<sup>43</sup> A fund

would reasonably believe that an acquired fund was in compliance with these provisions if, for example, it received a representation from the acquired fund (or the adviser to the acquired fund) that the fund would comply with the relevant provisions in all material respects and if the acquiring fund had no reason to believe that the acquired fund was not, in fact, complying with the relevant provisions in all material respects. Thus, an acquired fund’s failure to comply will not automatically result in the loss of the acquiring fund’s exemption.

#### (c) Closed-End Funds of Funds

The exemptions we are adopting are also available for closed-end funds, including business development companies,<sup>44</sup> which are closed-end funds that are exempted from registration under the Act.<sup>45</sup> In response to comments, the final rule provides an additional exemption from section 57 of the Act, which restricts certain transactions between business development companies and certain of their affiliates.<sup>46</sup> This relief is consistent with the relief we are granting from section 17(a) and rule 17d-1 with respect to affiliated money market funds. We agree with the commenter that the possibility of self-dealing or overreaching in the case of business development companies that invest in

were a registered open-end fund, with provisions of the Act that limit affiliate transactions (sections 17(a), (d), and (e)), issuance of senior securities (section 18), and suspension of redemption rights (section 22(e)). Rule 12d1-1(b)(2)(i)(B). The fund also must reasonably believe that the unregistered money market fund (i) has adopted and periodically reviews procedures designed to ensure compliance with these requirements, and maintains books and records describing the procedures, and (ii) maintains and preserves the books and records required under rules 31a-1(b)(1) [17 CFR 270.31a-1(b)(1)], 31a-1(b)(2)(ii) [17 CFR 270.31a-1(b)(2)(ii)], 31a-1(b)(2)(iv) [17 CFR 270.31a-1(b)(2)(iv)], and 31a-1(b)(9) [17 CFR 270.31a-1(b)(9)]. Rule 12d1-1(b)(2)(i)(C), (D).

<sup>44</sup> A business development company is any closed-end fund that: (i) Is organized under the laws of, and has its principal place of business in, any state or states; (ii) is operated for the purpose of investing in securities described in section 55(a)(1)-(3) of the Act [15 U.S.C. 80a-54(a)(1)-(3)] and makes available “significant managerial assistance” to the issuers of those securities, subject to certain conditions; and (iii) has elected under section 54(a) of the Act to be subject to the sections addressing activities of business development companies under the Act. See 15 U.S.C. 80a-2(a)(48). Section 60 of the Act [15 U.S.C. 80a-59] extends the limits of section 12(d) to a business development company to the same extent as if it were a registered closed-end fund.

<sup>45</sup> Section 6(f) of the Act [15 U.S.C. 80a-6(f)] exempts from registration and other provisions of the Act companies that have elected to be regulated as business development companies under section 54 [15 U.S.C. 80a-53].

<sup>46</sup> 15 U.S.C. 80a-56. See Comment Letter of IMRC Group (Nov. 18, 2003).

money market funds does not appear to be any greater than investments in money market funds by registered closed-end funds.

#### (d) Unregistered Funds of Funds

Unregistered funds also are subject to the section 12(d)(1) restrictions on the acquisition of shares of registered funds.<sup>47</sup> As proposed, the final rule permits unregistered funds to invest their cash in shares of a registered money market fund. This allows a hedge fund, for example, to sweep its cash into a registered money market fund pending investment or distribution of the cash to investors. In the Proposing Release, we asked whether any special concerns arise with respect to unregistered funds’ use of money market funds in cash sweep arrangements, and we received no comment on the question.

## 2. Conditions

As proposed, we are eliminating most of the conditions that have been included in our exemptive orders.<sup>48</sup> One condition we have retained precludes the acquiring fund from paying a sales load, distribution fee, or service fee on acquired fund shares, or if it does, the acquiring fund’s investment adviser must waive a sufficient amount of its advisory fee to offset the cost of the loads or distribution fees.<sup>49</sup> Rarely do institutional investors (such as an acquiring fund) pay sales loads or bear distribution expenses on an investment in a money market fund. Thus, a money market fund that charges a sales load or

<sup>47</sup> See 15 U.S.C. 80a-12(d)(1)(A); 15 U.S.C. 80a-12(d)(1)(B). In the case of unregistered investment companies (such as most foreign funds) the full restrictions of sections 12(d)(1)(A) and (B) apply. Companies that are unregistered because they are excepted from the definition of investment company by sections 3(c)(1) and 3(c)(7) of the Act are prohibited from acquiring more than three percent of the outstanding voting securities of a registered fund. Both section 3(c)(1) and section 3(c)(7) deem issuers that rely on these sections to be investment companies for the purposes of sections 12(d)(1)(A)(i) and 12(d)(1)(B)(i) with respect to their acquisition of registered funds. See 15 U.S.C. 80a-3(c)(1); 15 U.S.C. 80a-3(c)(7)(D).

<sup>48</sup> See Proposing Release, *supra* note 4, at n. 36.

<sup>49</sup> See Rule 12d1-1(b)(1). As discussed in the Proposing Release, we did not propose to limit the amount an acquiring fund could invest in a money market fund because a fund’s own investment restrictions should provide appropriate investment limitations. See Proposing Release, *supra* note 25, at text following n. 64. With respect to cash sweeps into unregistered money market funds, we have also retained the requirement in our prior exemptive orders that the money market funds operate as if they were money market funds registered under the Act. As proposed (unlike our exemptive orders), the final rule requires the acquiring fund to “reasonably believe,” rather than “determine,” that the unregistered money market funds operate in this manner. See *supra* notes 40-43 and accompanying text; see, e.g., Putnam Order, *supra* note 25.

<sup>37</sup> See 15 U.S.C. 80a-3(c)(1) (excepting from the definition of “investment company” an issuer whose securities are owned by no more than 100 persons and which is not making and does not presently propose to make a public offering of its securities); 15 U.S.C. 80a-3(c)(7) (excepting from the definition of “investment company” an issuer whose securities are owned exclusively by “qualified purchasers” and which is not making and does not presently propose to make a public offering of its securities).

<sup>38</sup> See *supra* notes 27-29 and accompanying text.

<sup>39</sup> We have made a technical change to conform the wording in paragraphs 12d1-1(b)(2)(i)(A) through (E) by adding to paragraph 12d1-1(b)(2)(i) the words “satisfies the following conditions as if it were a registered open-end investment company.”

<sup>40</sup> See 17 CFR 270.2a-7.

<sup>41</sup> Rule 12d1-1(d)(2)(ii).

<sup>42</sup> Rule 12d1-1(b)(2)(ii). In order for a registered fund to invest in reliance on rule 12d1-1 in an unregistered money market fund that does not have a board of directors (because, for example, it is organized as a limited partnership), the unregistered money market fund’s investment adviser must perform the duties required of a money market fund’s board of directors under rule 2a-7. Rule 12d1-1(d)(2)(ii)(B).

<sup>43</sup> Rule 12d1-1(b)(2)(i). To rely on the rule, an acquiring fund must reasonably believe that the unregistered money market fund complies, as if it

distribution fees to the acquiring fund may not be an appropriate investment for that fund. Commenters who addressed the issue generally supported this condition.<sup>50</sup>

Unlike our prior exemptive orders, the rule does not limit advisory fees or require directors to make any special findings that investors are not paying multiple advisory fees for the same service.<sup>51</sup> A fund could pay duplicative fees if an adviser invests a fund's cash in a money market fund (which itself pays an advisory fee) without reducing its advisory fee by an amount it was compensated to manage the cash. As we noted in the Proposing Release, fund directors have fiduciary duties,<sup>52</sup> which obligate them to protect funds from being overcharged for services provided to the fund, regardless of any special findings we might require. Moreover, and as we describe in more detail below, we have adopted amendments to the disclosure rules that require a registered fund of funds to disclose to shareholders expenses paid by both the acquiring and acquired funds so that shareholders may better evaluate the costs of investing in a fund with a cash sweep arrangement.<sup>53</sup>

<sup>50</sup> See Comment Letter of IMRC Group (Nov. 18, 2003). One commenter recommended we impose another condition to allow a money market fund to limit the percentage of fund assets that another fund complex can redeem during a business day as long as the limits are disclosed in the money market fund's registration statement. *Id.* We do not believe this is necessary in the context of money market funds, which are designed to easily accommodate large redemptions. Money market funds with large investors, such as a fund of funds, may need to pay particularly close attention to their obligations under rule 2a-7, however, because a large redemption may result in a growth in any deviation between the fund's net asset value per share, as computed using available market quotations, and the money market fund's amortized cost per share.

<sup>51</sup> See Proposing Release, *supra* note 4, at n. 65 and accompanying text.

<sup>52</sup> See *id.*, at n. 66 and accompanying text; see also 15 U.S.C. 80a-35(a). See generally 2 T. Frankel, *The Regulation of Money Managers*, § 9.05 (2001). Section 15(c) of the Act requires the board of directors to evaluate the terms (which would include fees, or the elimination of fees, for services provided by an acquired fund's adviser) of any advisory contract. See 15 U.S.C. 80a-15(c). Section 36(b) of the Act [15 U.S.C. 80a-35(b)] imposes on fund advisers a fiduciary duty with respect to their compensation. We believe that to the extent advisory services are being performed by another person, such as the adviser to an acquired money market fund, this fiduciary duty would require an acquiring fund's adviser to reduce its fee by the amount that represents compensation for the services performed by the other person. See Proposing Release, *supra* note 4, at n.66.

<sup>53</sup> Of course, disclosure of the cumulative amount of fees does not absolve the directors of their obligations to evaluate fund expenses. See *supra* note 52; Investment Company Governance, Investment Company Act Release No. 26520 (July 27, 2004) [69 FR 46378 (Aug. 2, 2004)], at text accompanying n.17. Nevertheless, we believe that the disclosure requirements are essential because

### B. Rule 12d1-2: Affiliated Funds of Funds

As discussed above, section 12(d)(1)(G) permits a registered open-end fund to acquire an unlimited amount of shares of registered open-end funds and UITs that are part of the same "group of investment companies" as the acquiring fund.<sup>54</sup> We proposed to codify, and in some cases expand, three types of relief we have provided for these fund of funds arrangements that we concluded were consistent with the public interest and the protection of investors, but that did not conform to section 12(d)(1)(G) limits. We proposed to permit an affiliated fund of funds to make investments in addition to shares of funds in the same group of investment companies. Commenters supported the proposal, and we are adopting rule 12d1-2 substantially as proposed.<sup>55</sup>

#### 1. Investments in Unaffiliated Funds

Rule 12d1-2 permits an affiliated fund of funds to acquire securities of funds that are not part of the same group of investment companies, subject to the limits in section 12(d)(1)(A) or 12(d)(1)(F).<sup>56</sup> This exemption, in effect,

they provide investors with the relevant information to compare directly the costs of investing in alternative funds of funds, or the costs of investing in a fund of funds to a more traditional fund.

<sup>54</sup> See *supra* notes 12-17 and accompanying text.

<sup>55</sup> See, e.g., Comment Letter of IMRC Group (Nov. 18, 2003); Comment Letter of ICI (Dec. 3, 2003); Comment Letter of Man Investments, Inc. (Dec. 1, 2003). The other limitations in section 12(d)(1)(G) will continue to apply to a fund of funds relying on that provision. One commenter requested expanding relief under rule 12d1-2 to permit funds to obtain shares of an acquired fund using in-kind transfers and exempt such transactions from the "for cash" requirement of rule 17a-7 under the Act. See Comment Letter of ICI (Dec. 3, 2003). That relief is outside the scope of our proposal.

<sup>56</sup> Rule 12d1-2(a)(1). A fund relying on section 12(d)(1)(A) (together with any companies or funds it controls) could not acquire more than 3 percent of the outstanding voting securities of any other fund in a different fund group. In addition, the acquiring fund would be limited to investing no more than 5 percent of its own assets (together with assets of any companies it controls) in the securities of any one fund in a different fund group, and no more than 10 percent of its assets (together with assets of any companies it controls) in securities of other funds in one or more different fund groups, in the aggregate. See 15 U.S.C. 80a-12(d)(1)(A)(i)-(iii). A fund relying on section 12(d)(1)(F) (together with its affiliates) could not acquire more than 3 percent of the outstanding stock of any other fund in a different fund group. The acquiring fund also would be required either to seek instructions from its shareholders as to how to vote shares of those acquired funds, or to vote the shares in the same proportion as the vote of all other shareholders of the acquired fund. See 15 U.S.C. 80a-12(d)(1)(F) (referencing 15 U.S.C. 80a-12(d)(1)(E)). In addition, the acquiring fund would be limited to charging a sales load of 1½ percent on its shares and could be prevented from redeeming more than 1 percent of the shares of any acquired fund during any period of less than 30 days. *Id.*

permits funds to combine the relief provided by the statutory exceptions. There do not appear to be any greater risks to an acquired fund or its shareholders if three percent of its shares are acquired by an affiliated fund of funds as opposed to being acquired by other types of funds specifically permitted to purchase shares by section 12(d)(1)(A) or 12(d)(1)(F).<sup>57</sup>

#### 2. Investments in Other Types of Issuers

Rule 12d1-2 also provides an exemption from section 12(d)(1)(G) of the Act to permit an affiliated fund of funds to invest directly in stocks, bonds, and other types of securities (*i.e.*, securities not issued by a fund).<sup>58</sup> Those investments would, of course, have to be consistent with the fund's investment policies.<sup>59</sup> A significant consequence of the rule is that an equity or bond fund can invest any portion of its assets in an affiliated fund if the acquisition is consistent with the investment policies of the fund and the restrictions of the rule.<sup>60</sup> Commenters agreed that these investments 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.<sup>61</sup>

#### 3. Investments in Money Market Funds

Rule 12d1-2 permits an affiliated fund of funds to invest in affiliated or unaffiliated money market funds in reliance on rule 12d1-1, which, as discussed above, is designed to permit cash sweep arrangements involving money market funds.<sup>62</sup> This provision

<sup>57</sup> A commenter also suggested that we clarify the scope of rule 12d1-2(a)(1) because it could be read to subject investments in registered funds in the same complex as the acquiring fund to the limits of sections 12(d)(1)(A) or 12(d)(1)(F). See Comment Letter of ICI (Dec. 3, 2003). We agree, and the final rule clarifies that the limits apply only to investments in securities of unaffiliated funds rather than registered funds in the same complex. See rule 12d1-2(a)(1).

<sup>58</sup> Rule 12d1-2(a)(2). Under this exemption, a fund may invest in any security as that term is defined under the Act. See 15 U.S.C. 80a-2(a)(36).

<sup>59</sup> See Item 4 of Form N-1A (requiring disclosure of fund's investment objectives and principal investment strategies).

<sup>60</sup> See Proposing Release, *supra* note 4, at nn. 81-82 and accompanying text. To the extent that a fund that normally invests directly in securities begins to make investments in affiliated funds in reliance on the rule, we would expect the fund's directors to be aware of the investments, particularly in the context of their consideration of potentially duplicative fees. See *supra* notes 52-53 and accompanying text.

<sup>61</sup> See Comment Letter of ICI (Dec. 3, 2003); Comment Letter of IMRC Group (Nov. 18, 2003).

<sup>62</sup> Rule 12d1-2(a)(3). See *supra* notes 23-50 and accompanying text. A collateral effect of our rule is

allows the affiliated fund of funds the same opportunities as any other fund to invest in a cash sweep arrangement that will provide the greatest benefit to the acquiring fund. As proposed, we are conditioning the investment on compliance with rule 12d1-1 in order to ensure that the same limitations on sales loads and distribution expenses apply to any fund's investment in a money market fund. Thus, any fund that invests in a money market fund in reliance on rule 12d1-2 must comply with the conditions in rule 12d1-1.

### C. Rule 12d1-3: Unaffiliated Funds of Funds

Section 12(d)(1)(F) of the Act provides an exemption from section 12(d)(1) that allows a registered fund to invest all its assets in other registered funds if: (i) The acquiring fund (together with its affiliates) acquires no more than 3 percent of the outstanding stock of any acquired fund; and (ii) the sales load charged on the acquiring fund's shares is no greater than 1½ percent.<sup>63</sup>

Rule 12d1-3 allows funds relying on section 12(d)(1)(F) to charge sales loads greater than 1½ percent provided that the aggregate sales load any investor pays (*i.e.*, the combined distribution expenses of both the acquiring and acquired funds) does not exceed the limits on sales loads established by the NASD for funds of funds.<sup>64</sup> The rule is

to permit an affiliated fund of funds to invest in an acquired fund that itself has a cash sweep arrangement. As discussed above, section 12(d)(1)(G) prohibits a fund from acquiring shares of another fund that does not have an investment policy prohibiting it from investing in shares of funds in reliance on section 12(d)(1)(F) or (G). An acquired fund investing in a money market fund under a cash sweep arrangement permitted under rule 12d1-1 would not be relying on either of those sections. The fees and expenses of acquired funds would be aggregated and shown in the fee table in the acquiring fund's prospectus. See discussion below at Section II.D of this release.

We are not, as one commenter suggested, providing expanded section 17 relief under rule 12d1-2. See Comment Letter of IMRC Group (Nov. 18, 2003). Affiliated funds of funds' investments in money market funds will be made in reliance upon rule 12d1-1, and we are including additional relief from certain provisions of rule 17e-1 in rule 12d1-1. We do not believe it is necessary to provide a duplicative exemption under rule 12d1-2. See *supra* notes 32-35 and accompanying text.

<sup>63</sup> See 15 U.S.C. 80a-12(d)(1)(F)(i)-(ii). Section 12(d)(1)(F) also provides that the acquired fund is not obligated to redeem more than 1 percent of its outstanding securities held by the acquiring fund in any period of less than 30 days, and requires the acquiring fund to vote shares of an acquired fund either by seeking instructions from the acquiring fund's shareholders or by voting in the same proportion as the other shareholders of the acquired fund.

<sup>64</sup> See NASD Sales Charge Rule 2830(d)(3), *supra* note 16. We note that any fund relying on the exemption provided in rule 12d1-3 must comply with the limitations set forth in NASD Sales Charge Rule 2830(d)(3), regardless of whether sales of the

intended to provide funds greater flexibility in structuring sales loads, consistent with the approach Congress took in section 12(d)(1)(G) to prevent excessive sales loads in affiliated funds of funds, while providing shareholders greater protection by requiring that funds relying on the rule limit overall distribution fees (rather than only sales loads).<sup>65</sup> We are adopting this rule substantially as proposed.<sup>66</sup>

### D. Amendments to Disclosure Forms: Transparency of Fund of Funds Expenses

We are also adopting amendments to our disclosure requirements to require each fund that invests in shares of other funds to disclose in its prospectus fee table the expenses of funds in which it invests. The amendments are designed to provide investors with a better understanding of the actual costs of investing in a fund that invests in other funds, which have their own expenses that may be as high or higher than the acquiring fund's expenses.<sup>67</sup> Investors may not be aware of these potentially higher expenses. Most commenters supported these amendments, which we are adopting substantially as proposed.<sup>68</sup>

*Open-End Funds.* Form N-1A is used by open-end management funds to register under the Act and to offer their securities under the Securities Act.

fund's shares by broker-dealers are otherwise subject to the rule according to its terms. See NASD Sales Charge Rule 2830(d) (NASD Sales Charge Rule limits apply to sales of open-end funds, any closed-end funds that make periodic repurchase offers under rule 23c-3(b) under the Act and offer their shares on a continuous basis, or single payment plans issued by UITs). Unlike the proposal, the final rule text limits sales charges and service fees charged with respect to the acquiring fund, but the rule does not specifically limit those fees when aggregated with sales charges and service fees charged with respect to acquired funds. The additional language on aggregation is not necessary in the rule because limits in NASD Sales Charge Rule 2830(d)(3) specifically apply to fees imposed by the acquiring fund, the acquired fund and those funds in combination.

<sup>65</sup> See Proposing Release, *supra* note 4, at n. 88 and accompanying text. An affiliated fund of funds may rely on rule 12d1-2 to invest in funds in a different fund complex subject to the limits of section 12(d)(1)(A) or 12(d)(1)(F). If the acquiring fund's investment is subject to the limits of section 12(d)(1)(F), the acquiring fund may also rely on the exemption provided under rule 12d1-3 to charge sales loads greater than 1½ percent provided it complies with the conditions of rule 12d1-3.

<sup>66</sup> Commenters generally supported this provision. See Comment Letter of ICI (Dec. 3, 2003); Comment Letter of FMR (Dec. 19, 2003).

<sup>67</sup> A fund of funds may have higher fees and expenses than a fund that invests directly in debt and equity securities.

<sup>68</sup> See Comment Letter of ICI (Dec. 3, 2003); Comment Letter of FMR (Dec. 19, 2003) (supporting position taken in the ICI comment letter); Comment Letter of IMRC Group (Nov. 18, 2003); Comment Letter of Joel Torrance (June 17, 2004).

Form N-1A sets forth the disclosure requirements for fund prospectuses. Our amendments to Form N-1A require any registered open-end fund investing in shares of another fund to include in its prospectus fee table an additional line item titled "Acquired Fund Fees and Expenses" under the section that discloses total annual fund operating expenses.<sup>69</sup> The line item will set forth the acquiring fund's pro rata portion of the cumulative expenses charged by funds in which the acquiring fund invests. Those costs will be included in the acquiring funds' total annual fund operating expenses, which will be reflected in the "Example" portion of the fee table.<sup>70</sup> One commenter suggested that we add an instruction to permit a fund to omit the new separate line item if the aggregate expenses attributable to acquired funds do not exceed 0.01 percent (one basis point) of average net assets of the acquiring fund. We agree with the commenter that the disclosure of this *de minimis* amount in a separate line item would not be important to investors. Therefore, the instructions to the amended fee table allow these expenses to be included in "Other Expenses."<sup>71</sup>

We also are adopting instructions to assist an acquiring fund in determining the amount of acquired funds' fees and expenses that must be reflected in its fee

<sup>69</sup> The item will appear directly above the line item titled "Total Annual Fund Operating Expenses." The proposed instructions to Form N-1A would have permitted funds to use terms in the fee table other than the term "Acquired Fund." We received no comment in response to our question whether the proposed instructions were consistent with the current fee table. We have decided not to permit funds to use other terms, however, because no variation is permitted for other line items in the fee table (except for the subcaptions that may be used under "Other Expenses" in order to identify the largest expenses comprising "Other Expenses"). Accordingly, the instruction, as adopted, is consistent with the other line items in the expense table, and allows investors to more easily compare disclosure among funds. In the event a fund uses another defined term to describe acquired funds in its prospectus, it may include this term in a parenthetical following the title of the new line item. See Instruction 3(f)(i) to Item 3 of Form N-1A. We are adopting conforming amendments to Forms N-2 and N-3. See Instruction 10.a to Item 3.1 of Form N-2; Instruction 19(a) to Item 3(a) of Form N-3.

<sup>70</sup> The fee table example requires the fund to disclose the cumulative amount of fund expenses of 1, 3, 5, and 10 years based on a hypothetical investment of \$10,000 and an annual 5 percent return. See Item 3 of Form N-1A.

<sup>71</sup> See Comment Letter of ICI (Dec. 3, 2003). See Instruction 3(f)(i) to Item 3 of Form N-1A. Inclusion of the *de minimis* amount under "Other Expenses," however, ensures that the acquired funds' expenses will be included in the acquiring fund's total annual operating expense ratio. Form N-2 and Form N-3 filers may also rely on this exception and we have amended the relevant instructions accordingly. See Instruction 10.a to Item 3.1 of Form N-2; Instruction 19(a) to Item 3(a) of Form N-3.

table. The acquiring fund must aggregate the amount of total annual fund operating expenses of acquired funds (which are indirectly paid by the acquiring fund) and transaction fees (which are directly paid by the acquiring fund over the past year) and express the total amount as a percentage of average net assets of the acquiring fund. Under this approach, the acquiring fund must determine the average invested balance and number of actual days invested in each acquired fund.<sup>72</sup> We also are adopting the proposed instruction that requires the acquiring fund to include in the expense calculation any transaction fee the acquiring fund paid to acquire or dispose of shares of a fund during the past fiscal year (even if it no longer holds shares of that fund).<sup>73</sup>

<sup>72</sup> See Instruction 3(f)(ii) to Item 3 of Form N-1A (to calculate the pro rata share of total annual fund operating expenses for each acquired fund, an acquiring fund will divide the acquired fund's expense ratio by the number of days in the relevant calendar year, and multiply the result by the average invested balance and the number of days invested in the acquired fund). We have revised the divisor in the calculation for the daily expense ratio from the proposed 365 days to the number of days in the fiscal year to reflect that some fiscal years will have 366 days. One commenter asserted that our proposed formula in Instruction 3(f)(ii) to Item 3 of Form N-1A would not correspond to the expense ratio (*i.e.*, the Ratio of Expenses to Average Net Assets) currently in Item 8 of Form N-1A, "Financial Highlights Information." The commenter stated that, as a result, the total annual fund operating expenses disclosed in response to Item 3 would be generally higher than those reflected in response to Item 8 because the expense ratio in Item 8 would only reflect expenses paid directly by the acquiring fund. See Comment Letter of ICI (Dec. 3, 2003). We agree that this potential discrepancy may be confusing to investors, and have revised the instruction to permit funds to address this discrepancy in a clarifying footnote to the fee table. See Instruction 3(f)(vii) to Item 3 of Form N-1A. Because Form N-2 and Form N-3 filers would face the same issue, the adopted instructions permit those funds also to include a clarifying footnote. See Instruction 10.i to Item 3.1 of Form N-2; Instruction 19(g) to Item 3(a) of Form N-3. We also have directed the staff to continue monitoring funds of funds' disclosure to determine whether additional disclosure of acquired funds' fees is needed, such as in the financial highlights section or shareholder reports.

We are also revising Instruction 3(f)(v) to Item 3 of Form N-1A. The proposed instructions would have required the acquiring fund to calculate an "average invested balance" based on month-end balances. One commenter recommended that funds be permitted to calculate "average invested balances" based on the value of investment measured no less frequently than monthly to allow funds the flexibility of using daily balances. See Comment Letter of ICI (Dec. 3, 2003). We believe that the recommendation will allow the most accurate disclosure for funds that use the more frequent measure and have revised the instruction to allow the acquiring fund to calculate "average invested balance" based on the value of investment measured no less frequently than monthly. See Instruction 10.e to Item 3.1 of Form N-2; Instruction 19(e) to Item 3 of Form N-3.

<sup>73</sup> See Instruction 3(f)(ii) to Item 3 of Form N-1A ("transaction fees" included in the calculation for

Our proposed instructions would have required an acquiring fund in the same fund complex as the acquired fund to calculate the acquired fund's actual total annual expense ratio for the period covering the acquiring fund's fiscal year.<sup>74</sup> For funds in a different fund complex, our proposal would have required the acquiring funds to use the gross expense ratio disclosed in an acquired fund's most recent semi-annual report filed with the Commission, or if the fund does not file reports with the Commission or the gross expense ratio is not provided, to use the expense ratio provided in a recent communication from the acquired fund.<sup>75</sup>

One commenter questioned whether funds in the same fund complex should have to calculate this special purpose expense ratio and recommended that an acquiring fund use the acquired fund's annual expense ratio as disclosed in its most recent semi-annual report filed with the Commission.<sup>76</sup> We agree with the commenter that it is unnecessary to calculate a special purpose expense ratio for funds in the same fund complex because expense ratios typically do not fluctuate much from year to year. Therefore, acquired fund expense disclosure based on a special purpose expense ratio would in most cases be identical to or negligibly different from the disclosure based on the expense ratio as disclosed in the most recent shareholder report. Accordingly, the instructions as adopted require an acquiring fund to calculate the acquired funds' expenses using the net expense ratios reported in the acquired funds' most recent shareholder reports.<sup>77</sup> We also believe that allowing

acquired funds' fees and expenses include the total amount of sales loads, redemption fees, or other transaction fees paid by the acquiring fund in connection with acquiring or disposing of shares in acquired funds during the year). We clarified this instruction to indicate that "transaction fees" include fees paid in connection with acquiring and disposing of shares. If an acquired fund charges a performance fee, the fee would be included in the disclosure of acquired funds' fees and expenses. The amended instructions to Form N-1A would require an acquiring fund to include a performance fee that is accounted for as an incentive allocation, in conformance with the amended instructions to Form N-2. See *infra* notes 83, 84.

<sup>74</sup> See Proposing Release, *supra* note 4.

<sup>75</sup> *Id.*

<sup>76</sup> See Comment Letter of ICI (Dec. 3, 2003).

<sup>77</sup> See Instruction 3(f)(iv) to Item 3 of Form N-1A. The proposal would have required acquiring funds to use a gross expense ratio, which would have excluded the effect of waivers or reimbursements. Amended instruction 3(f)(iv) requires use of the net operating expense ratio, which includes the effect of waivers or reimbursements by the acquired fund's investment adviser or sponsor. We believe that permitting funds to use the net operating expense ratio that is disclosed in shareholder reports instead of the gross expense ratio (which

acquiring funds to use the net expense ratio disclosed in shareholder reports (which may or may not be filed with the Commission depending on whether the fund is registered with the Commission), instead of reports filed with the Commission, will permit more acquiring funds to rely on a readily available expense ratio and will eliminate the need for any special communication between the funds.<sup>78</sup> If an acquired fund does not provide a net expense ratio in its most recent shareholder report or is a newly formed fund that has not prepared a report, the acquiring fund must use the acquired fund's total annual fund operating expenses over average annual net assets as reported in its most recent communication to the acquiring fund.<sup>79</sup>

The new disclosure requirements we are adopting today also will apply with respect to investments in any unregistered fund that would be an investment company under section 3(a) of the Act but for the exceptions provided in sections 3(c)(1) and 3(c)(7) of the Act.<sup>80</sup> Thus, a fund with a cash sweep arrangement will be required to report the expenses of the unregistered money market fund in which the acquiring fund invests.

**Closed-End Funds.** Form N-2 is used by closed-end management funds to register under the Act and to offer their securities under the Securities Act. Closed-end funds sometimes invest in other funds and unregistered pools of investments, such as hedge funds.<sup>81</sup> The

may not be available in shareholder reports because it is not required disclosure) will significantly reduce the need for special calculations or communications between the acquiring and acquired fund because the acquiring fund will not have to adjust the net expense ratio disclosed in the shareholder report to exclude the effect of waivers and reimbursements. We have made conforming amendments to Forms N-2 and N-3. See Instruction 10.d to Item 3.1 of Form N-2; Instruction 19(d) to Item 3(a) of Form N-3.

<sup>78</sup> Funds may use the most recent shareholder report, whether it is an annual or semi-annual report. If the acquiring fund relies on a semi-annual report, however, it must use an annualized expense ratio. See Instruction 3(f)(iv) to Item 3 of Form N-1A; Instruction 10.d to Item 3.1 of Form N-2; Instruction 19(d) to Item 3(a) of Form N-3.

<sup>79</sup> See Instruction 3(f)(iv) to Item 3 of Form N-1A. We also are conforming the instruction with respect to the expense ratio used for funds in a different fund complex in order to establish a uniform instruction. We believe that this revision will provide greater consistency among funds of funds' expense disclosures. *Id.* We have made conforming changes to Forms N-2 and N-3. See Instruction 10.d to Item 3.1 of Form N-2; Instruction 19(d) to Item 3 of Form N-3.

<sup>80</sup> See Instruction 3(f)(i) to Item 3 of Form N-1A, Instruction 10.a to Item 3.1 of Form N-2, Instruction 19(a) to Item 3 of Form N-3. See also 15 U.S.C. 80a-3(c)(1), 80a-3(c)(7), and *supra* note 37.

<sup>81</sup> Hedge funds are often "private funds" as defined in rule 203(b)(3)-1(d) of the Investment

amendments to Form N-2 require a registered closed-end fund of funds (including a closed-end fund of hedge funds) to include its pro rata portion of the cumulative expenses charged by the acquired funds, including management fees and expenses, transaction fees and performance fees (including incentive allocations), as a line item in its fee table.<sup>82</sup> As adopted, the instructions provide generally that any incentive allocations (fees based on a share of income, capital gains and/or appreciation) must be reflected in the acquired fund's fees and expenses.<sup>83</sup>

Advisers Act of 1940. 17 CFR 275.203(b)(3)-1(d) (a "private fund" is a fund (i) that would be an investment company under section 3(a) of the Investment Company Act but for the exceptions to that definition in sections 3(c)(1) and 3(c)(7) of the Act, (ii) that permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests, and (iii) interests in which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser). See also Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004) [69 FR 72054 (Dec. 10, 2004)], at Section II.E. Closed-end funds also may invest in private equity funds, venture capital funds, or other funds that generally require capital contributions over the life of the fund and the long-term commitment of capital. See *id.* at nn. 224-225.

<sup>82</sup> See Instruction 10 to Item 3.1 of Form N-2. Consistent with the required disclosure of master-feeder funds' expenses under Form N-1A, the instructions to Form N-2 clarify that in the event a closed-end fund of funds is a master-feeder fund, the feeder fund must disclose in its fee table the aggregate expenses of the feeder fund and master fund. The aggregate expenses of the master fund must also include fees and expenses incurred indirectly by the feeder fund as a result of the master fund's investment in shares of one or more acquired funds. See Instruction 10.h to Item 3.1 of Form N-2. See also Proposing Release, *supra* note 4, at n. 90.

As with a fund of registered funds, investors may not be aware that a fund of hedge funds may have higher fees and expenses than an alternate fund of funds or a fund that invests directly in debt and equity securities. See NASD Investor Alert, Funds of Hedge Funds—Higher Costs and Risks for Higher Potential Returns (Aug. 23, 2002) (available at: [http://www.nasd.com/Investor/alerts/alert\\_hedgefunds.htm](http://www.nasd.com/Investor/alerts/alert_hedgefunds.htm)); Stephen J. Brown, William N. Goetzmann, and Bing Liang, Fees on Fees in Funds of Funds, 3 (Yale International Center for Finance Working Paper No. 02-33, June 14, 2004). See also *supra* note 67.

<sup>83</sup> See Instruction 10.b to Item 3.1 of Form N-2. The adviser of an acquired fund may charge its shareholders a fee based on a share of income, capital gains and/or appreciation of the assets of the shareholder in the acquired fund. This fee, which is paid to the adviser or an affiliate, is called either a performance fee or an incentive allocation depending on the way the acquired fund accounts for it in its financial statements. Performance fees are reflected in the acquired fund's statement of operations, but incentive allocations are reported in the statement of changes of capital. The effect of this accounting treatment is that performance fees are included in the acquired fund's expense ratio reported in the shareholder report but incentive allocations are not.

Therefore, in order to provide complete disclosure of fees incurred when funds invest in hedge funds, we are requiring acquiring funds to

Each acquiring closed-end fund must determine expenses attributable to its investments in acquired funds during the most recent fiscal year together with, if applicable, any investments it intends to make with the proceeds of its present offering. The instructions require a fund to reflect the amount of expenses attributed to the intended investments assuming those investments had been held by the acquiring fund during its most recent fiscal year.<sup>84</sup> Given the extensive due diligence that we understand fund of hedge fund managers undertake in order to create an investment strategy for the fund, we believe that each acquiring fund should be able to provide these estimates of expenses based on written fee arrangements with acquired funds in which it invests or intends to invest.<sup>85</sup>

One commenter opposed our proposed disclosure requirement for a fund of hedge funds for several

include these incentive allocations in the formula for calculating acquired funds' fees and expenses. We have made conforming amendments to Form N-1A. See Instruction 3(f)(ii) to Item 3 of Form N-1A.

<sup>84</sup> See Instruction 10.f to Item 3.1 of Form N-2. The instructions to Item 3.1 clarify that an acquiring fund must use the expenses (of assumed investments) for the previous fiscal year rather than predict expenses of the acquired funds in which the acquiring fund assumes it will invest. The instructions further clarify that acquiring funds must include anticipated net proceeds from the offering in the average invested balance in each acquired fund and the average net assets of the acquiring fund. See Instructions 10.c and 10.f to Item 3.1 of Form N-2. This treatment is consistent with the treatment for funds offering shares under Form N-1A. See Instruction 3(f)(vi) to Item 3 of Form N-1A. The instructions also clarify that a fund that intends to invest in a fund that has no operating history should include fees to be paid to the adviser to that fund (or its affiliate) as disclosed in the registration statement, offering memorandum or similar document without giving effect to any performance component. See Instruction 10.d to Item 3.1 of Form N-2. We have made conforming amendments to Form N-1A. See Instruction 3(f)(iv) to Item 3 of Form N-1A.

<sup>85</sup> Typically, funds of hedge funds invest in 15 to 25 hedge funds. See Rory B. O'Halloran, *An Overview and Analysis of Recent Interest in Increased Hedge Fund Regulation*, 79 Tul. L. Rev. 461, 480 (2004). Most hedge fund investors perform extensive due diligence prior to making initial and subsequent investments. According to a survey of institutional investors, 60 percent of institutional investors take between two to six months to complete due diligence on a single hedge fund. Deutsche Bank, *Equity Prime Services Alternative Investment Survey Results Part 2: Inside the Mind of the Hedge Fund Investor*, Mar. 2003, at 1, 7. One manager of a fund of hedge funds estimates that initial due diligence on a single hedge fund manager takes 3 to 4 weeks. See George Van, *The Smartest Way to Invest in Hedge Funds*, available at [http://www.hedgefund.com/smartest/Smartest\\_Way\\_professional.pdf](http://www.hedgefund.com/smartest/Smartest_Way_professional.pdf). In light of our understanding that fund of hedge funds managers engage in this time consuming initial diligence, we believe that a fund is likely to have an investment allocation strategy prior to filing its registration statement and, therefore, would be able to make the necessary assumptions in order to provide the required disclosure.

reasons.<sup>86</sup> The commenter questioned whether disclosure based on historical hedge fund expenses may be misleading because future expenses could differ materially due to the impact on performance fees of fund performance and portfolio changes. The commenter also expressed concern that investors may conclude that the acquired funds' expenses are fixed costs and not subject to change over time.<sup>87</sup> The commenter expressed concern that the potential fluctuation in acquired fund fees and expenses might require a fund of hedge funds to continually monitor its disclosure to guard against material misstatements or omissions in its registration statement.<sup>88</sup>

The Commission understands that the presentation of acquired hedge fund fees and expenses poses particular challenges for funds of hedge funds because their fees may be more variable than other types of pooled investment vehicles, such as mutual funds. The commenter's suggestion to disclose the estimated ranges of fees that hedge funds could charge in a footnote or in text somewhere other than in the fee table would not improve transparency of expenses. While the amount of acquired fund expenses may vary, they are expenses that we believe should be included in the total annual fund operating expenses disclosed to investors in order to provide them a more complete presentation of the aggregate direct and indirect costs of investing in a fund of funds.

We believe that we can address the commenter's concerns and still provide investors in funds of hedge funds with a better understanding of the multiple

<sup>86</sup> See Comment Letter of Man Investments, Inc. (Dec. 1, 2003).

<sup>87</sup> The commenter also asserted that the instructions could inaccurately portray expenses of acquired hedge funds because fees may vary widely among investors in a hedge fund as a result of individual rates negotiated through side letters. *Id.* We share the commenter's concern. Accordingly, the final instructions require the acquiring fund to rely on the expense ratio in the shareholder report or, if applicable, any written fee agreements with acquired hedge funds to determine acquired fund fees and expenses. See Instruction 10.d to Item 3.1 of Form N-2.

<sup>88</sup> See Comment Letter of Man Investments, Inc. (Dec. 1, 2003). The commenter also stated its belief that actual returns over time are the most important factor in comparing funds of hedge funds. We do not disagree that actual returns over time are a relevant factor for investors to consider. We believe, however, that the required disclosure will assist a fund of hedge funds investor in making an informed investment decision as to whether the benefit of diversification provided by investing in a fund of hedge funds outweighs any layering of costs. We also continue to believe that the disclosure will provide investors with the relevant information to compare directly the costs of investing in alternative funds of funds, or the costs of investing in a fund of funds to a more traditional fund. See *supra* note 53.

layers of fees that are charged in a fund of hedge funds investment. To accomplish this, first we have revised the instructions to require a fund of hedge funds to include in a footnote to the new line item the typical performance fee charged by acquired hedge funds in which it invests. The footnote also would alert investors that acquired hedge fund fees are based on historical expenses and could be substantially higher or lower due to potential fluctuations in acquired hedge fund performance.<sup>89</sup> Second, we have provided an exception that allows funds to exclude from the expense ratio disclosed in the fee table acquired fund performance fees that are calculated solely on the realization and/or distribution of gains or the sum of the realization and/or distribution of gains and unrealized appreciation of assets distributed in-kind.<sup>90</sup> This type of performance fee is typically paid by a private equity fund upon liquidation of the fund or when a fund has terminated an investment and distributed the proceeds or the appreciated assets to investors.<sup>91</sup> We agree that in these circumstances, the performance fees associated with a particular period may be unrelated to the costs of investing in a fund of funds.<sup>92</sup>

**Insurance Company Separate Accounts.** We received no specific comments on our proposed amendments to Forms N-3, N-4 and N-6, and we are adopting them substantially as proposed.<sup>93</sup> These forms will require separate accounts to include disclosures regarding the

expenses of acquired funds in their prospectuses.<sup>94</sup>

### III. Paperwork Reduction Act

Rule 12d1-1 will impose a new "collection of information" requirement within the meaning of the Paperwork Reduction Act of 1995 ("PRA").<sup>95</sup> The title of the new collection is "Rule 12d1-1." Rule 12d1-1 permits a fund to invest in unregistered money market funds notwithstanding the limitations of section 17 and rule 17d-1, if the unregistered money market funds meet certain conditions under rule 2a-7 of the Act and preserve records under rule 31 of the Act. Both rules 2a-7 and 31 contain collection of information requirements. Compliance with the collection of information requirements of rule 12d1-1 is necessary to obtain a benefit for unregistered money market funds that seek investments by registered funds that may be made only in reliance on rule 12d1-1. Responses to the collection of information requirements of rule 12d1-1 will not be kept confidential.

In the Proposing Release, Commission staff estimated that the annual hour burden of the proposed rule's collection of information requirements for unregistered money market fund compliance with rule 2a-7 would be 21,175 hours.<sup>96</sup> The staff also estimated that the requirements under rules 31a-1(b)(1), 31a-1(b)(2)(ii), 31a-1(b)(2)(iv), and 31a-1(b)(9) would not impose any additional burden because the costs of maintaining records would be incurred by unregistered money market funds in any case to keep books and records that are necessary to prepare financial statements for shareholders, to prepare the fund's annual income tax returns, and as a normal business practice.<sup>97</sup> We submitted the collection for rule 12d1-

1 to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. No commenters addressed these burden estimates for the collection of information requirements, and we continue to believe that they are appropriate. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. OMB approved the collection of information under control number 3235-0212 (expiring on May 31, 2007).<sup>98</sup>

In addition, the Commission is adopting amendments to certain forms that currently contain mandatory "collection of information" requirements. The titles for the existing collections are: (i) "Form N-1A under the Securities Act of 1933 and the Investment Company Act of 1940, Registration Statement of Open-End Management Investment Companies;" (ii) "Form N-2 under the Securities Act of 1933 and the Investment Company Act of 1940, Registration Statement of Closed-End Management Investment Companies;" (iii) "Form N-3 under the Securities Act of 1933 and the Investment Company Act of 1940, Registration Statement of Separate Accounts Organized as Management Investment Companies;" (iv) "Form N-4 under the Securities Act of 1933 and the Investment Company Act of 1940, Registration Statement of Separate Accounts Organized as Unit Investment Trusts;" and (v) "Form N-6 under the Securities Act of 1933 and the Investment Company Act of 1940, Registration Statement of Separate Accounts Organized as Unit Investment Trusts that Offer Variable Life Insurance Policies." The amendments require that investors in a registered fund of funds receive more transparent disclosure of the costs of investing in these arrangements. The disclosure is designed to provide investors with a more complete presentation of the actual costs of investing in a fund that invests in other funds, which have their own expenses that may be as high or higher than the acquiring fund's expenses. Compliance with the disclosure requirements of Forms N-1A, N-2, N-3, N-4 and N-6 is mandatory. Responses to the disclosure requirements will not be kept confidential.

In the Proposing Release, Commission staff estimated that the amendment to

<sup>89</sup> See Instruction 10.g to Item 3.1 of Form N-2. The footnote could, for example, state:

[Some/All] Acquired Funds in which the Registrant invests charge a performance fee based on the Acquired Funds' earnings. The "Acquired Fund Fees and Expenses" disclosed above are based on historic earnings of the Acquired Funds, which may change substantially over time and, therefore, significantly affect Acquired Fund Fees and Expenses. The typical performance fee charged by Acquired Funds in which the Registrant invests is [INSERT PERCENTAGE].

<sup>90</sup> See Instruction 10.d to Item 3.1 of Form N-2. We have made a conforming change to the instructions for Form N-1A. See Instruction 3(f)(iv) to Item 3 of Form N-1A.

<sup>91</sup> See James M. Schell, *Private Equity Funds, Business Structure and Operations* §§ 1.03[3][a], 1.04[3][a] (2006).

<sup>92</sup> In contrast, hedge funds generally charge performance fees that are calculated as a percentage of the hedge fund's net investment income, realized capital gains and unrealized capital appreciation. See Staff of U.S. Securities and Exchange Commission, *Report to the Commission on Implications of the Growth of Hedge Funds* (2003) at text preceding n. 212.

<sup>93</sup> As with the instructions to Forms N-1A and N-2, the instructions to Form N-3 require that the line item expense disclosure be titled: "Acquired Fund Fees and Expenses." See *supra* note 69 and accompanying text.

<sup>94</sup> The amended instructions to Form N-3 require the same disclosure and calculation as required in the amended instructions to Forms N-1A and N-2. The amended instructions for Forms N-4 and N-6 are different from the instructions in Forms N-1A, N-2, and N-3, however, because Forms N-4 and N-6 already require registrants (*i.e.*, separate accounts) to disclose expenses of funds ("portfolio companies") in which the separate account invests. See Item 3 of Form N-4; Item 3 of Form N-6. Accordingly, the amended instructions to Forms N-4 and N-6 require that if a portfolio company invests in other (acquired) funds, the separate account must include in the item disclosing the portfolio company's "other expenses," the acquired funds' fees and expenses calculated according to the instructions to Form N-1A. Unlike the proposal, the instructions refer specifically to portfolio companies instead of using the term "Acquiring Fund" in describing the disclosure of acquired funds' fees and expenses incurred by the portfolio company.

<sup>95</sup> 44 U.S.C. 3501.

<sup>96</sup> See Proposing Release, *supra* note 4, at n. 138 and accompanying text.

<sup>97</sup> *Id.* at text following n. 138.

<sup>98</sup> We are adopting rule 12d1-1 with some modifications, which are described in Section II of this release. None of the modifications affects the PRA analysis or collection of information burden approved by OMB.

the disclosure requirement will add up to 7 hours per portfolio to the existing hour burden associated with completing Forms N-1A, N-2 and N-3, and 0.5 hours to the existing hour burden associated with completing Forms N-4 and N-6.<sup>99</sup> No commenters addressed the burden estimates for the collection of information requirements associated with Forms N-1A, N-3, N-4 and N-6, and we continue to believe that they are appropriate.<sup>100</sup>

One commenter, a fund of hedge funds, disagreed with our Form N-2 estimate. The commenter asserted that calculating the costs would entail vast amounts of time by numerous personnel reviewing a large number of hedge funds that provide information in varying formats. The commenter added that it believes a fund of hedge funds would be required to monitor and recalculate actual performance fees paid on an ongoing basis to guard against a material misstatement in the fee table.<sup>101</sup> The commenter provided cost estimates but did not provide any specific estimates of burden hours. Funds offering their shares on a continuous or delayed basis in reliance on Rule 415 under the Securities Act must update their registration statements under certain circumstances.<sup>102</sup> We have revised the

PRA estimate to reflect staff estimates that funds offering their shares on a continuous basis file updated registration statements on at least an annual basis. The revised estimated annual burden per fund of hedge fund is 213 hours.<sup>103</sup>

Based on recent Commission filings, 23 registered funds of hedge funds offer their shares on a continuous basis under rule 415 of the Securities Act. Therefore, the staff estimates the additional annual burden for funds of hedge funds to update the acquired fund expenses in their prospectuses pursuant to the requirements of section 10(a)(3) of the Securities Act is 2450 hours.<sup>104</sup>

Item 34.4.a of Form N-2. In the release adopting Rule 415, the Commission noted that "the term 'fundamental' is intended to reflect current staff practice under which post-effective amendments are filed when major and substantial changes are made to information contained in the registration statement. Material changes that can be stated accurately and succinctly in a short sticker will continue to be permitted. While many variations in matters such as operating results, properties, business, product development, backlog, management and litigation ordinarily would not be fundamental, major changes in the issuer's operations, such as significant acquisitions or dispositions, would require the filing of a post-effective amendment. Also, any change in the business or operations of the registrant that would necessitate a restatement of the financial statements always would be reflected in a post-effective amendment." See Adoption of Integrated Disclosure System, Securities Act Release No. 6383 (Mar. 3, 1982) [47 FR 11380 (Mar. 16, 1982)] at text accompanying nn.79-81. See also Guide 8 to Form N-2. In addition, purchasers of an issuer's securities in a registered offering have private rights of action for materially deficient disclosure in prospectuses and oral communications under section 12(a)(2) of the Securities Act. See 15 U.S.C. 77j(a)(2); see also Securities Offering Reform, Securities Act Release No. 8591 (July 19, 2005) [70 FR 44722 (Aug. 3, 2005)] at Section IV.A (discussing information conveyed by the time of sale for purposes of liability under section 12(a)(2)).

<sup>103</sup> The increase in annual hour burden was estimated using an average of the range of costs the commenter estimated a fund of hedge funds would incur to prepare the disclosure (\$16,500) and dividing that cost by the estimated hourly cost to prepare the disclosure:  $\$16,500 \div \$77.42 = 213.12$ . Therefore, the estimated total annual burden per fund of hedge funds to prepare the disclosure is 213 hours. The estimated hourly cost is the weighted average of the cost to prepare the disclosure for other closed-end funds ( $\$404$  (cost of 6 hours of an accountant's time) +  $\$138$  (cost of 1 hour of an attorney's time)  $\div 7 = \$77.42$ ). See *infra* note 120. This estimate also includes the costs of including the footnote to the line item that discloses the typical performance fee charged by the hedge funds in which the acquiring fund invests or intends to invest.

<sup>104</sup> Any post-effective amendment to a registration statement filed to update the information in the prospectus for purposes of section 10(a)(3) of the Securities Act or to reflect fundamental changes in the information in the prospectus contained in the registration statement would also revise the information regarding the acquired funds' fees and expenses. Because only a portion of acquired funds' fees and expenses may be updated in the annual post-effective amendment to reflect additional or revised fees and expenses, since the date of the last updating, resulting from existing, newly acquired or

Based on recent filings, Commission staff estimates that, on an annual basis, registrants file 234 initial registration statements (of which 11 are funds of hedge funds) and 38 post-effective amendments (including 23 post-effective amendments for funds of hedge funds in continuous registration). The current estimated total annual burden for the preparation and filing of Form N-2 is 120,673 hours.<sup>105</sup> Accordingly, we estimate the total annual burden for all funds for the preparation and filing of initial registrations statements and post-effective amendments to Form N-2 would be 125,389 hours.<sup>106</sup>

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. We submitted the collections of information associated with Forms N-1A, N-2, N-3, N-4 and N-6 to OMB to review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. OMB approved the collections of information under control numbers 3235-0307 (Form N-1A, expiring on December 31, 2007), 3235-0026 (Form N-2, expiring on January 31, 2008, revised submission currently under review by OMB), 3235-0316 (Form N-3, expiring on July 31, 2007), 3235-0318 (Form N-4, expiring on March 31, 2007), and 3235-0503 (Form N-6, expiring on March 31, 2007).

#### IV. Cost-Benefit Analysis

We are sensitive to the costs and benefits imposed by our rules. As discussed above in sections II.A—II.C, the new rules provide relief to funds by providing additional exemptions from

to be acquired funds, the Commission estimates that a fund of hedge funds in continuous offering would spend approximately 50% of the time it takes to determine the initial acquired hedge funds disclosure (213 hours) to review and update its calculation of acquired funds' fees and expenses prior to filing a post-effective amendment. Therefore, the annual burden for funds of hedge funds in continuous registration is an additional 2450 hours ( $(213 \text{ hours} \div 2 = 106.5 \text{ hours}) (106.5 \text{ hours} \times 23 \text{ funds} = 2449.5 \text{ hours})$ ).

<sup>105</sup> The Commission made this estimate in connection with its submission for approval of recent proposed amendments to Form N-2. See Executive Compensation and Related Party Disclosure, Investment Company Act Release No. 27218 (Jan. 27, 2006) [71 FR 6542 (Feb. 8, 2006)].

<sup>106</sup> This estimate is based on the following calculation:  $120,673 + 2450 + (11 \times 206) = 125,389$ . The current estimated total annual hour burden already incorporates the time estimated in the proposing release to prepare the disclosure required by the amendments (7 hours for each closed-end fund that invests in other funds). The revised estimate includes the additional 206 hours (213 minus 7 hours included in the approved total annual hour burden) the staff estimates it may take a closed-end fund of hedge funds to complete the required disclosure, based on the commenter's cost estimates.

<sup>99</sup> See Proposing Release, *supra* note 4, at nn.139-161 and accompanying text.

<sup>100</sup> We have revised the final instructions for calculating acquired funds' expenses as described above. See *supra* notes 77-79 and accompanying text. Although the staff believes that these modifications may provide funds with some time and cost savings, we are not changing our hour burden estimates. We will review the estimates when the collection of information requirements must be resubmitted for review, and at that time we will be able to consider funds' actual experience in complying with them.

<sup>101</sup> See Comment Letter of Man Investments, Inc. (Dec. 1, 2003).

<sup>102</sup> See 17 CFR 230.415. Section 10(a)(3) of the Securities Act provides that "when a prospectus is used more than nine months after the effective date of the registration statement, the information contained therein shall be as of a date not more than sixteen months prior to such use so far as such information is known to the user of such prospectus or can be furnished by such user without unreasonable effort or expense." 15 U.S.C. 77j(a)(3). In general, funds that are offering their securities on a continuous or delayed basis in reliance on Rule 415 file annual post-effective amendments to update the prospectus in the registration statement pursuant to section 10(a)(3). In addition to the statutory provisions of section 10(a)(3), Rule 415 and Form N-2 require that the registrant undertake to file a post-effective amendment to reflect: (i) any prospectus required by section 10(a)(3) of the Securities Act; (ii) facts or events arising after the effective date that "represent a fundamental change in the information set forth in the registration statement;" and (iii) material information with respect to the plan of distribution not disclosed previously in the registration statement or any material change to such information in the registration statement. See 17 CFR 230.415(a)(3);

the limitations on fund of funds arrangements without requiring the funds or their advisers to obtain an exemptive order. As discussed in section II.D, the amendments to Forms N-1A, N-2, N-3, N-4, and N-6 provide additional information to shareholders regarding the costs of acquired funds in a fund of funds arrangement.

#### A. Rules 12d1-1, 12d1-2 and 12d1-3

We have issued a number of exemptive orders that have broadened the ability of funds to invest in other funds and provided certain funds of funds greater flexibility in structuring their sales charges. These orders have provided exemptions from statutory limitations. A fund that has obtained the benefit of an exemption has incurred costs of applying for an exemptive order as well as costs of satisfying any conditions imposed in the order. Application costs are primarily legal and include costs of drafting the application and analyzing the ways in which the conditions fit the fund's business model. The costs of satisfying conditions include ongoing compliance costs of meeting those conditions. We assume that a fund only seeks an exemptive order if the benefits of the additional flexibility provided by the exemption outweigh the costs of obtaining and satisfying the conditions of an order. We solicited but did not receive comments with respect to the cost-benefit analysis for rules 12d1-1, 12d1-2 and 12d1-3.

#### 1. Benefits

Rule 12d1-1 codifies our prior exemptive orders that permit a fund to invest all or a portion of its available cash in money market funds rather than directly in short-term instruments. The rule retains one condition included in our orders that the acquiring fund pays no sales load or distribution or service fee on the acquired money market fund shares unless the acquiring fund's investment adviser waives a sufficient amount of its advisory fee to offset the cost of those fees.<sup>107</sup> We believe that any further restrictions on an acquiring fund's investments in money market funds should be governed by the fund's investment policies and limitations and the fiduciary obligations of its board of

<sup>107</sup> With respect to investments in unregistered money market funds, we also have retained the requirement in our prior exemptive orders that the money market funds operate as if they were money market funds registered under the Act. Unlike our exemptive orders, however, and as we proposed, we are requiring the acquiring fund to reasonably believe, rather than to determine, that the unregistered money market funds operate in this manner. See *supra* notes 40-43 and accompanying text; see, e.g., Putnam Order, *supra* note 25.

directors. Consequently, we believe that the rule will provide greater flexibility for certain funds than exemptive orders we have issued.

Under the rule, funds also may invest in money market funds advised by a different adviser. We believe that this will allow all funds, particularly small funds without a money market fund in their fund group, the opportunity currently available to large funds to engage in cash sweep arrangements. In addition, we have provided additional relief under section 17 of the Act. If a fund in one fund complex acquired more than five percent of the assets of a money market fund in another complex, any broker-dealer affiliated with the money market fund would become a (second-tier) affiliated person of the acquiring fund. As a result of the affiliation, the broker-dealer's fee for effecting the sale of securities to the acquiring fund would be subject to the conditions set forth in rule 17e-1, including the quarterly board review and recordkeeping requirements with respect to certain securities transactions involving the affiliated broker-dealer.<sup>108</sup> The final rule permits an acquiring fund to pay commissions, fees, or other remuneration to an affiliated broker-dealer without complying with the quarterly board review and recordkeeping requirements set forth in rules 17e-1(b)(3) and 17e-1(d)(2).<sup>109</sup> This relief is available only if the broker-dealer and the acquiring fund become affiliated solely because of the acquiring fund's investment in the money market fund. We believe this additional relief will enable more funds to take advantage of the exemption provided by the rule.

Rule 12d1-1 also codifies our orders permitting funds to invest in unregistered money market funds that operate like a money market fund registered under the Act. The acquiring fund is required to "reasonably believe" that the unregistered money market fund operates in compliance with rule 2a-7 and complies with certain provisions of the Act, as well as other requirements.<sup>110</sup> This standard is slightly different than the condition in our exemptive orders, which requires the acquiring fund to determine that the acquired fund is in compliance with rule 2a-7 and certain provisions of the Act. A fund would reasonably believe that an acquired fund was in compliance with these provisions if, for example, it received a representation from the acquired fund (or the adviser

<sup>108</sup> See *supra* note 34.

<sup>109</sup> See *supra* notes 32-36 and accompanying text.

<sup>110</sup> See *supra* notes 40-43 and accompanying text.

to the acquired fund) that the fund would comply with the relevant provisions in all material respects and if the acquiring fund had no reason to believe that the acquired fund was not, in fact, complying with the relevant provisions in all material respects. Thus, an acquired fund's failure to comply will not automatically result in the loss of the acquiring fund's exemption. Rule 12d1-1 does not include certain conditions imposed in the exemptive orders that we believe are already adequately addressed by other provisions of the Act or rules thereunder.<sup>111</sup>

Rule 12d1-2 codifies, and in some cases expands upon, three types of relief that we provided to affiliated funds of funds. The rule permits affiliated funds of funds to acquire up to three percent of the securities of funds that are not part of the same group of investment companies, subject to the limits in section 12(d)(1)(A) or 12(d)(1)(F) of the Act. The rule also permits an affiliated fund of funds to acquire securities not issued by a fund. These investments would have to be consistent with the fund's investment policies. Finally, the rule permits affiliated funds of funds to invest in affiliated or unaffiliated money market funds in reliance on rule 12d1-1.

Rule 12d1-3 codifies the exemptive orders we have issued permitting funds relying on section 12(d)(1)(F) to charge a sales load greater than 1½ percent provided that the aggregate sales load any investor pays (*i.e.*, the combined distribution expenses of both the acquiring and acquired funds) does not exceed the limits on sales loads established by the NASD for funds of funds. This exemption also would be available to an affiliated fund of funds relying on rule 12d1-2 to invest in funds in a different fund group.

We anticipate that funds and their shareholders will benefit from the rules. Funds increasingly have sought exemptive orders (which the Commission has granted) to engage in most of the activities the rules permit. The application process involved in obtaining exemptive orders imposes direct costs on funds, including preparation and revision of an application, as well as consultations with the staff. The rules will benefit funds and their shareholders by eliminating the direct costs of applying to the Commission to engage in activities permitted under the rules.<sup>112</sup>

<sup>111</sup> See Proposing Release, *supra* note 4, at n. 49.

<sup>112</sup> For example, in calendar years 2003 and 2004, 11 funds sought exemptive relief to invest uninvested cash and/or cash collateral from

The rules will further benefit funds by eliminating the uncertainty that a particular applicant might not obtain relief to engage in the activities permitted under the rules.

The exemptive application process also involves other indirect costs. Funds that apply for an order to permit additional investments forgo potentially beneficial investments until they receive the order, while other funds forgo the investment entirely rather than seek an exemptive order because they have concluded that the cost of seeking an exemptive order would exceed the anticipated benefit of the investment. Eliminating direct and indirect costs of the proposed activities also eliminates factors that discriminate against smaller funds, for which the cost of an exemptive application can often exceed the potential benefit.

## 2. Costs

We do not believe that the rules will impose mandatory costs on any fund. As discussed above, the rules are exemptive, and we believe that a fund would not rely on any of them if the anticipated benefits did not justify the costs. We believe the costs of relying on the rules will be the same as or less than the costs to a fund that relies on an existing exemptive order because each of the rules includes the same or fewer conditions than existing orders that provide equivalent exemptive relief.<sup>113</sup>

The rules will affect different types of funds in different ways. A fund that has not sought and would not seek exemptive relief from section 12(d)(1) of the Act will not be affected by the rules. The cost for a fund that currently relies on exemptive relief covered by our rules will be the same as or less than the costs of relying on its exemptive order

securities lending activities in money market funds, and 3 of those funds also sought exemptive relief to invest cash collateral in unregistered money market funds. In the past 5 years, 9 funds investing in other funds in the same fund group in reliance on section 12(d)(1)(G) have sought exemptive relief to invest in securities other than government securities or short-term paper. During that time, 9 funds investing in other funds in reliance on section 12(d)(1)(F) have sought exemptive relief to charge a sales load greater than 1½ percent, subject to the NASD Sales Charge Rule. In the Proposing Release, we estimated that the cost to a fund for submitting one of these applications ranges from \$7,000 to \$67,000. See Proposing Release, *supra* note 4, at n. 125. We did not receive any comments on these estimates and continue to believe that they are appropriate.

<sup>113</sup> Our analysis compares the costs a fund would bear to comply with the rules with the costs a fund would bear under the current system of obtaining equivalent exemptive relief. Because the conditions in the rules are the same or less onerous than the conditions in the exemptive orders, the costs discussed in this section primarily are costs that a fund would bear to obtain an exemptive order and comply with its conditions.

because the rules contain the same or fewer conditions than existing orders.<sup>114</sup> In addition, a fund that currently relies on an exemptive order can satisfy all the conditions of any of the rules that provide similar exemptive relief without changing its operation. For example, in the case of rule 12d1-1, the fund will simply be satisfying conditions that are no longer required.<sup>115</sup> Finally, a fund that has not relied on an exemptive order and that intends to rely on one of the rules will bear the same continuing costs of complying with conditions that it would have borne had it obtained an exemptive order. In that case, its total costs would have been the same as or greater than the costs associated with the rules.

## B. Amendments to Forms N-1A, N-2, N-3, N-4, and N-6

Forms N-1A, N-2 and N-3 currently do not require registered funds to disclose information regarding the expenses associated with acquired funds. The amendment to Form N-1A requires a registered open-end fund that invests in other funds to include a line item in its fee table, under the total annual fund operating expenses, that lists the aggregate fees and costs of acquired funds. The amendment to Form N-2 requires registered closed-end funds that invest in other funds to provide the same disclosure.<sup>116</sup> The amendment to Form N-3 requires the same disclosure for separate accounts organized as management investment companies that offer variable annuity contracts. The new disclosure requirements include instructions on calculating the fees and operating costs of acquired funds. The calculation will aggregate the annual fund operating expenses of acquired funds, transaction costs and, as applicable, incentive allocations incurred by the acquiring fund, and express the aggregate fees as a percentage of average net assets of the acquiring fund.

<sup>114</sup> Such a fund may face a one-time "learning cost" to determine the difference between the fund's exemptive order and the rule. We do not believe this cost would be significant given the similarity of conditions in our rules and existing exemptive orders.

<sup>115</sup> We note that a fund may choose to rely on an existing exemptive order and comply with the conditions of that order. 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 rules we are adopting today.

<sup>116</sup> In addition, closed-end funds of hedge funds must add a footnote to the line item that discloses the typical performance fee charged by acquired hedge funds in which the acquiring fund invests.

Forms N-4 and N-6 currently require separate accounts organized as UITs that offer variable annuity and variable life contracts, respectively, to disclose the range of minimum and maximum operating expenses of the portfolio companies in which they invest. The amendment to each of these forms requires a separate account organized as a UIT that invests in a portfolio company that itself invests in other funds, to include the portfolio company's costs of investing in other funds in the portfolio company's operating expenses disclosed in the Form N-4 or Form N-6 fee table.

## 1. Benefits

Under current disclosure requirements, a fund's shareholders may not understand the fees and operating costs of a fund's investment in acquired funds, costs that investors bear indirectly. We believe that the amendments to Forms N-1A, N-2, N-3, N-4, and N-6 will enable shareholders to better understand the expenses that relate to acquired funds, and provide investors the means to compare directly the costs of investing in alternative funds of funds, or the costs of investing in a fund of funds to a more traditional fund. The increased transparency may provide further benefits by allowing investors to choose funds that more closely reflect their preferences for fees and performance.<sup>117</sup>

## 2. Costs

The amendments to Forms N-1A, N-2, N-3, N-4, and N-6 will result in costs to registered open-end and closed-end funds, and to separate accounts that offer variable annuity and variable life contracts, which may be passed on to those funds' shareholders. The amendments will require a new disclosure to the annual operating expense item in the fee table for funds that invest in other funds. It also will require separate accounts organized as UITs that offer variable annuity and variable life contracts to include an additional expense in their calculations of annual portfolio company operating expenses. The costs of the disclosures will include both internal costs (for attorneys and accountants) to prepare and review the disclosure, and external costs (for printing and typesetting the disclosure).

First, with respect to Forms N-1A, N-2 and N-3, the disclosures will add a single line item to the fee table for funds

<sup>117</sup> We requested comments as well as any quantifying data in the Proposing Release, but did not receive any.

that invest in other funds.<sup>118</sup> In the context of the prospectus for Forms N-1A, N-2 and N-3, we believe that the external costs of including this additional line of disclosure per registered fund will be minimal.<sup>119</sup> With respect to Forms N-4 and N-6, the disclosure will require registrants to include in the item for annual portfolio company operating expenses, any fees and expenses of acquired companies, as disclosed in the portfolio company's most recent prospectus. Accordingly, we believe there will be no additional external costs for Forms N-4 and N-6 as a result of the amendments.

Second, for purposes of the PRA, Commission staff estimated in the proposal that the disclosure requirement for calculating the line item according to the instructions will add up to 7 hours per portfolio to the burden of completing Forms N-1A, N-2 and N-3. Commission staff further estimated that the additional annual cost of including the line item per portfolio would equal \$542.<sup>120</sup>

<sup>118</sup> We are permitting acquiring funds to omit a separate line item if the amount of expenses attributable to acquired funds does not exceed 0.01 percent (one basis point) of average net assets, and to include these expenses in "Other Expenses." See Instruction 3(f)(i) to Item 3 of Form N-1A; Instruction 10.a to Item 3.1 of Form N-2; Instruction 19(a) to Item 3(a) of Form N-3.

<sup>119</sup> We also believe the costs to the acquiring fund of preparing the footnote to the line item that discloses the typical performance fee charged by hedge funds in which the acquiring fund invests will be minimal.

<sup>120</sup> In the Proposing Release, Commission staff estimated the additional burden would equal 6 hours for an intermediate level accountant and 1 hour for a deputy general counsel to review the calculation per portfolio. See Proposing Release, *supra* note 4, at n.127. We did not receive any comments on these hourly estimates and continue to believe that they are appropriate. We have, however, updated our wage estimates based on current wage data for professionals in the financial services industry available at <http://www.careerjournal.com/salaryhiring> (last visited July 28, 2005).

In order to determine who would be an intermediate level accountant in the new source, we looked at years of experience. We believe that accountants with 6 to 15 years of experience would fall within that category. The national average salary for these accountants is \$89,749 ((\$85,483 (6-10 years of experience) + \$94,015 (11-15 years of experience)) ÷ 2 = \$89,749). Adjusting this salary upwards by 35% to reflect possible overhead costs and employee benefits, the staff estimates that the annual adjusted salary would be \$121,161, and the cost for 6 hours of an intermediate level accountant's time would be \$404 (\$121,161 ÷ 1,800 hours × 6 = \$403.87). The staff estimates the national average salary for a deputy general counsel is \$183,675. Adjusting this salary upwards by 35% to reflect possible overhead costs and employee benefits, the staff estimates that the annual adjusted salary would be \$247,961, and the cost for 1 hour of a deputy general counsel's time would be \$138 (\$247,961 ÷ 1,800 hours = \$137.76). Accordingly, the staff estimates the total cost for each portfolio to calculate the amended disclosure would equal \$542 (\$404 + \$138 = \$542). We have revised the

One commenter, a fund of hedge funds, disagreed with our estimates and asserted that the cost to a single fund of hedge funds to make an initial calculation each year would be between \$8,000 and \$25,000 depending on the number of personnel involved and the need for auditor review.<sup>121</sup> The commenter did not specify the number or functions of the personnel involved. We agree with the commenter that a fund of hedge funds may have additional costs. We estimate that the cost of adding the new line item for a fund of hedge funds is \$16,500.<sup>122</sup> Based on recent Commission filings, approximately 11 funds of hedge funds file initial registration statements on Form N-2 each year and their aggregate assets under management are \$958.2 million. The estimated aggregate costs for these funds of hedge funds to calculate the new line item is \$181,500.<sup>123</sup> We do not believe that the additional cost is significant given the funds of hedge funds' aggregate assets under management.<sup>124</sup>

On the assumption that funds of hedge funds would have to monitor current fees in order to guard against material misrepresentations in the fee table, the commenter estimated that these funds of hedge funds would face an additional monitoring cost of \$15,000 or more annually. As discussed in Section III above, staff estimates that the 23 funds of hedge funds registered under Form N-2 and offering their shares on a continuous basis file updated registration statements on at least an annual basis. We estimate the additional cost to review the disclosure will be \$8245 per fund of hedge funds and the total annual costs for funds of funds to update the acquired fund expenses in their prospectuses pursuant

final instructions for calculating acquired funds' expenses as described above. See *supra* notes 77-79 and accompanying text. Although the staff believes that these modifications may provide funds with some cost savings, we have not adjusted the hour burden estimates but will review them when the collection of information requirements must be resubmitted for review and funds will have had actual experience in complying with them.

<sup>121</sup> See Comment Letter of Man Investments, Inc. (Dec. 1, 2003).

<sup>122</sup> Because the commenter did not explain the underlying calculations for its range of costs, the estimate is based on the average of the \$8,000 to \$25,000 range provided by the commenter. The cost to each fund of hedge funds may be higher or lower depending on a variety of factors, including the number of hedge funds in which the fund of hedge funds invests.

<sup>123</sup> This calculation is based on the following: (11 × \$16,500) = \$181,500.

<sup>124</sup> The estimated cost of preparing the line item is 0.0189% of assets under management for funds of hedge funds in the aggregate (\$181,500 ÷ \$958.2 million).

to the requirements of section 10(a)(3) of the Securities Act will be \$189,635.<sup>125</sup>

Despite this additional cost, we continue to believe that the costs of the required disclosure are justified because the disclosure will assist a fund of hedge funds investor in making an informed investment decision as to whether the benefit of diversification provided by investing in a fund of hedge funds outweighs any layering of costs. We do not believe that other alternatives suggested by the commenter, such as simply disclosing a range of fees, would be a meaningful substitute. These alternatives would not meet our objective of improving transparency of expenses. Nor would they meet our objective to include acquired fund expenses in the total annual fund operating expenses disclosed to investors in order to provide them a more complete presentation of the aggregate direct and indirect costs of investing in a fund of funds. We continue to believe that our estimate is appropriate for Form N-2 registrants that are not funds of hedge funds.

In the Proposing Release, we also estimated that including the additional item in the disclosure of portfolio company expenses on Forms N-4 and N-6 would add approximately 0.5 hours per portfolio, which based on the updated wage estimates would be an annual cost per portfolio of \$34.<sup>126</sup> We did not receive any comments on this estimate and continue to believe that it is appropriate.

Based on Commission filings, the staff estimates that half the funds registered under Forms N-1A and N-2 (excluding funds of hedge funds) invest in other funds, all funds of hedge funds registered on Form N-2 invest in other funds, and 5 separate accounts (with 7 portfolios) registered under Form N-3 invest in other funds and will be required to make the proposed disclosure on an annual basis. For purposes of the PRA analysis, Commission staff has estimated that on an annual basis, registrants file (i) initial registration statements covering 483 portfolios and post effective amendments covering 6542 portfolios on Form N-1A, (ii) 234 initial

<sup>125</sup> See *supra* notes 102-104 and accompanying text. These estimates are based on the following calculations: 106.5 (hours per fund) × \$77.42 (estimated hourly cost to prepare the disclosure) = \$8245; \$8245 × 23 (funds) = \$189,635.

<sup>126</sup> Commission staff estimates the cost would equal 0.5 hours for an intermediate level accountant to include the expense item in the calculation. The estimated cost is based on the following calculation: 0.5 × \$67.3 = \$33.7. The estimated hourly cost for an intermediate level accountant is \$67 (\$121,161.15 (annual cost) ÷ 1,800 hours = \$67.31/hour). See *supra* note 120.

registration statements (of which 11 are funds of hedge funds) and 38 post-effective amendments on Form N-2, and (iii) initial registration statements covering 3 portfolios and post-effective amendments covering 35 portfolios on Form N-3. In addition, Commission staff also estimates that each year, 157 separate accounts file initial registrations and 1242 separate accounts file post-effective amendments on Form N-4, and 50 separate accounts file initial registrations and 500 separate accounts file post-effective amendments on Form N-6.<sup>127</sup> Of the filings on Forms N-4 and N-6, Commission staff estimates that half the separate accounts invest in portfolio companies that themselves invest in other funds. Thus, Commission staff estimates that the cost of the amendments to Forms N-1A, N-2, N-3, N-4, and N-6 to funds registering under these forms will be \$2.4 million.<sup>128</sup>

#### V. Consideration of Promotion of Efficiency, Competition, and Capital Formation

Section 2(c) of the Investment Company Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation.<sup>129</sup> We sought, but did not receive any comment with respect to this section.

##### A. Rules 12d1-1, 12d1-2 and 12d1-3

Rules 12d1-1, 12d1-2 and 12d1-3 will expand the circumstances in which funds can invest in other funds without first obtaining an exemptive order from the Commission, which can be costly and time-consuming. We anticipate that the rules will promote efficiency and competition. Rule 12d1-1 permits funds to acquire shares of money market funds in the same or in a different fund group in excess of the limitations in section

<sup>127</sup> Changes in estimates from the Proposing Release are due to updated PRA analyses for the relevant forms. Of the Form N-6 post-effective amendments, 150 are annual updates and 350 are additional post-effective amendments. As we said in the Proposing Release, we assume that registered funds would include the disclosure only in a post-effective amendment to the annual update. See Proposing Release, *supra* note 4, at n.132.

<sup>128</sup> The estimate is based on the following calculation:  $((483 + 6542) \div 2) \times \$542 + ((223 + 38) \div 2) \times \$542 + (11 \times \$16,500) + (23 \times \$8,245) + (7 \text{ separate account portfolios} \times \$542) + (((157 + 1,242) \div 2) \times \$34) + (((50 + 150) \div 2) \times \$34) = \$2,376,618$ . The increase in costs from the Proposing Release is due to adjustments for salary and overhead costs during the intervening period and the additional cost for funds of hedge funds to comply with the disclosure requirement.

<sup>129</sup> 15 U.S.C. 80a-2(c).

12(d)(1) of the Act. This exemption allows funds, particularly small funds without a money market fund in their complex, to allocate their uninvested cash more efficiently and thereby increase competition among funds. In addition, the final rule provides additional section 17 relief for funds that execute transactions with broker-dealers affiliated with money market funds in which the acquiring funds invest. This additional relief, we believe, will allow more funds to take full advantage of the exemption provided by the rule.<sup>130</sup> Rule 12d1-2 permits an affiliated fund of funds to acquire limited amounts of securities issued by funds outside the same fund group and securities not issued by a fund. The rule also permits a traditional equity or bond fund to invest in funds within the same fund complex. We believe that this expansion of investment opportunities will permit funds to allocate their investments more efficiently. Rule 12d1-3 allows funds relying on section 12(d)(1)(F) of the Act to charge sales loads greater than 1½ percent provided that the aggregate sales load any investor pays does not exceed the limits established by the NASD for funds of funds. We believe this will increase competition among funds as it will provide funds with greater flexibility in structuring their sales charges. We do not believe that these exemptive rules, which provide funds with greater flexibility in their investments and provide certain funds of funds greater flexibility in structuring their sales charges, will have an adverse impact on capital formation.

##### B. Amendments to Forms N-1A, N-2, N-3, N-4, and N-6

The form amendments are designed to provide better transparency for fund shareholders with respect to the costs of investing in funds of funds. The enhanced disclosure requirements will provide shareholders with greater access to information regarding the indirect costs they bear when a fund in which they invest purchases shares of other funds. This information should promote more efficient allocation of investments by investors and more efficient allocation of assets among competing funds because investors may compare and choose funds based on their preferences for cost more easily. The amendments may also improve competition, as enhanced disclosure may prompt funds to provide improved products and services that may have a greater appeal to investors. Enhanced disclosure also may prompt acquiring

funds to invest in acquired funds with lower costs. Finally, we do not believe that the amendments will have an adverse impact on capital formation. As discussed above, we believe that the amendments will benefit investors.

#### VI. Final Regulatory Flexibility Analysis

We have prepared this Final Regulatory Flexibility Analysis ("FRFA") in accordance with 5 U.S.C. 604. It relates to new rules 12d1-1, 12d1-2 and 12d1-3 under the Investment Company Act, and amendments to Forms N-1A, N-2, N-3, N-4, and N-6. The Commission prepared an Initial Regulatory Flexibility Analysis ("IRFA") in accordance with 5 U.S.C. 603, a summary of which was published in the Proposing Release.<sup>131</sup>

##### A. Need for the New Rules and Form Amendments

As described more fully in Section II of this release, we are adopting rules 12d1-1, 12d1-2 and 12d1-3 to address the ability of a registered fund to invest in shares of another fund without first having to seek Commission approval. The rules codify and expand upon a number of exemptive orders we have issued that permit funds to invest in other funds. The form amendments are a critical element of the relief we are adopting today and are designed to improve the transparency of the expenses of funds of funds by requiring that the expenses of the acquired funds be aggregated and shown as an additional expense in the fee table of the fund of funds.

##### B. Significant Issues Raised by Public Comment

In the IRFA for the proposed rules and form amendments, we requested comment on any aspect of the IRFA, including the number of small entities that are likely to rely on the proposed rules and amendments and the likely impact of the proposal on small entities. We received no comments on the IRFA.

##### C. Small Entities Subject to the New Rules and Form Amendments

For purposes of the Regulatory Flexibility Act, a fund is a small entity if the fund, together with other funds in the same group of related funds, has net assets of \$50 million or less as of the end of its most recent fiscal year.<sup>132</sup> The staff estimates, based upon recent Commission filings, that there are

<sup>131</sup> See Proposing Release, *supra* note 4, at Section VII.

<sup>132</sup> 17 CFR 270.0-10.

<sup>130</sup> See *supra* notes 32-36 and accompanying text.

approximately 4083 active registered funds and 88 business development companies, of which approximately 175 and 65 are small entities, respectively.<sup>133</sup> The staff estimates that no separate account is a small entity. A fund that is a small entity, like other funds, may rely on any of the exemptive rules if the fund satisfies the rule's conditions.

The Commission expects the new rules to have little impact on small entities. Like other funds, small entities will be affected by new rules 12d1-1, 12d1-2 and 12d1-3 only if they determine to use any of the exemptions provided by the rules. Few small entities have applied for relief to engage in the activities that will be permitted under the rules. The staff anticipates that the number of funds, including small funds, that will engage in the activities permitted under the rules, will increase. Nevertheless, the staff believes that the proportion of small entities compared to the total number of funds that engage in these activities will remain small.

The Commission expects that the amendments to Forms N-1A and N-2 will have a greater impact on small entities. The amendments require each registered fund, including each fund that is a small entity, that invests in any other fund to disclose the aggregate costs of investing in acquired funds. The staff estimates, based upon Commission filings, that 140 funds that file on Form N-1A, and 32 funds (of which 4 are funds of hedge funds)<sup>134</sup> that file on Form N-2 are small entities.<sup>135</sup> Commission staff also estimates that half of the funds registered under Forms N-1A and N-2 (excluding funds of hedge funds) invest in other funds, and all funds of hedge funds would be required to make the new disclosure.<sup>136</sup> Accordingly, we estimate that 70 funds that are small entities file on Form N-1A and 18 funds (including the 4 funds of hedge funds) that are small entities file on Form N-2 and would be required to make the new disclosure.

<sup>133</sup> Some or all of the funds may contain multiple series or portfolios. If a registered investment company is a small entity, the portfolios or series it contains are also small entities. The estimated number of small entities in the IRFA was based on filings with the Commission current at that time.

<sup>134</sup> The 4 funds of hedge funds that are small entities do not offer their shares continuously in reliance on rule 415 of the Securities Act.

<sup>135</sup> Amendments to Forms N-3, N-4, and N-6 are not expected to impact small entities because the staff estimates that no registered separate account is a small entity.

<sup>136</sup> This estimate is based on information in the Commission's database of Form N-SAR filings.

#### *D. Projected Reporting, Recordkeeping, and Other Compliance Requirements*

The new rules will not impose any mandatory reporting or recordkeeping requirements on any person and will not materially increase other compliance requirements. Rule 12d1-1 allows funds to invest in money market funds in excess of section 12(d)(1)(A) limits. The rule requires that either (i) the acquiring fund does not pay any sales charge, distribution fee or service fee (as defined by NASD Sales Charge Rule 2830(d)) on the purchase of money market fund shares, or (ii) the fund's adviser waives its fee in an amount necessary to offset any administrative fees of the money market fund.<sup>137</sup> This condition may reduce the cost of cash management (by reducing advisory or custodial fees relating to money market instruments) for large and small funds. In addition, under the rule, a fund that invests in an unregistered money market fund will have to "reasonably believe" that the unregistered fund (i) operates in compliance with rule 2a-7, and (ii) complies with certain provisions of the Act. With respect to these conditions, we believe that if the cost of investing in a money market fund (registered or unregistered) exceeds the costs of other forms of cash management, acquiring funds, including funds that are small entities, will not take advantage of the exemption. Finally, we believe the additional section 17 relief for acquiring funds that execute transactions with broker-dealers that are affiliated solely as a result of the acquiring fund's investment in a money market fund, will allow more funds to take full advantage of the exemption provided by the rule. We believe this additional relief will be important if a small fund without a money market fund in its complex invests, in reliance upon rule 12d1-1, in a money market fund in another complex and thereby becomes affiliated with a broker-dealer affiliated with the money market fund. Without the relief from certain recordkeeping and monitoring requirements, small funds may find it potentially costly or onerous to monitor transactions with affiliated broker-dealers.<sup>138</sup>

Rule 12d1-2 also has no mandatory reporting, recordkeeping or other compliance requirements.<sup>139</sup> Rule 12d1-3 requires an unaffiliated fund of funds relying on the rule to limit aggregate distribution-related costs

<sup>137</sup> Rule 12d1-1(b)(1).

<sup>138</sup> See *supra* notes 32-36 and accompanying text.

<sup>139</sup> Funds that invest in a money market fund in reliance on rule 12d1-2, however, must comply with the conditions of rule 12d1-1. See *supra* note 62 and accompanying text.

under the NASD Sales Charge Rule.<sup>140</sup> The rule provides funds greater flexibility in structuring sales loads, consistent with the approach Congress took in section 12(d)(1)(G) to prevent excessive sales loads in affiliated funds of funds, while providing shareholders greater protection by requiring that funds relying on the rule limit overall distribution fees (rather than only sales loads).

Funds that intend to rely on the rules will no longer incur the expense associated with filing applications for comparable exemptive relief from sections 12(d)(1)(A), (B), (F), and (G), 17(a), 17(e)(2)(A), and 57, and rules 17d-1, 17e-1(b)(3) and 17e-1(d)(2) in connection with the fund of funds arrangement permitted by the rules. The exemptive rules may be of greater benefit to small funds for which the benefits of obtaining an order for the relief described above may not sufficiently offset the costs of filing an exemptive application.

The amendments to Forms N-1A and N-2 require registered funds to include a line item in the fee table disclosing the acquiring fund's pro rata portion of the cumulative expenses charged by funds in which the acquiring fund invests. The amendments include instructions for calculating the line item "Acquired Fund Fees and Expenses." For purposes of the PRA, Commission staff estimated that the disclosure requirement for calculating the line item according to the instructions will add up to 7 hours per portfolio to the burden of completing Forms N-1A and N-2.<sup>141</sup> Commission staff also estimated that the additional cost of including the line item per portfolio would equal \$542 for Forms N-1A and Form N-2 (excluding funds of hedge funds).<sup>142</sup> The Commission staff has further estimated, based on comments received, that a fund of hedge funds would incur \$16,500 to calculate the new line item.<sup>143</sup> Assuming that half of all small funds and all small funds of hedge funds invest in other funds and will be required to include the additional disclosure, the Commission staff estimates that the maximum total annual cost for small entities to comply with the form amendments will be \$176,026.<sup>144</sup>

<sup>140</sup> See rule 12d1-3(a); See also *supra* note 64 and accompanying text.

<sup>141</sup> See *supra* notes 99-100 and accompanying text.

<sup>142</sup> See *supra* note 120 and accompanying text.

<sup>143</sup> See *supra* note 103 and accompanying text.

<sup>144</sup> Based on recent Commission filings, the staff estimates that 140 funds that are small entities are registered under Form N-1A, with an average of 2.7 portfolios per registrant. Commission staff further

### E. Commission Action To Minimize Effect on Small Entities

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the new rules, the Commission considered the following alternatives: (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the rule, or any part thereof, for small entities.

The new rules are exemptive, and compliance with them is voluntary. We therefore do not believe that special compliance, timetable, or reporting requirements or an exemption from coverage of the rules for small entities would be appropriate.

The rules do not require any reporting requirements that could be further clarified, consolidated, or simplified. Rule 12d1-1 uses performance rather than design standards to the extent it requires that acquiring funds "reasonably believe" that underlying funds are operating in compliance with rule 2a-7 and certain provisions of the Act. This standard is designed to ensure that a violation on the part of the acquired fund would not cause the acquiring fund to lose its exemption under the rule if it can demonstrate that it reasonably believed that the acquired fund was in compliance. In addition, rule 12d1-3 does not specify the sales load and distribution-related charges an acquiring or acquired fund must impose, but permits funds to determine the combined charges within the overall limit set by the NASD Sales Charge Rule.

With respect to the form amendments, we believe that any further clarification,

estimates that 28 funds registered with an average of 1.0 portfolio per registrant and 4 funds of hedge funds registered under Form N-2 are small entities. The staff's estimate assumes that all funds of hedge funds and half of all other portfolios would include the proposed disclosure. The maximum cost estimate is based on the following calculation:  $((140 \times 2.7) + (28 \times 1.00)) \times 2 \text{ portfolios} \times \$542 = \$110,026$  +  $(4 \times \$16,500 = \$66,000) = \$176,026$ . The increase from the Proposing Release is due to adjustments for salary and overhead costs during the intervening period and the additional cost for funds of hedge funds to comply with the disclosure requirement. Amendments to Forms N-3, N-4 and N-6 are not expected to impact small entities because the staff estimates that no registered separate account is a small entity.

consolidation, or simplification of the requirements to report expenses of acquired funds for small funds would not be consistent with the protection of investors. A different requirement, including differing compliance or reporting requirements or timetables, could compromise the intent to provide investors with cost information that will allow them to make direct comparisons to the costs of alternative fund of funds arrangements and to the costs of a more traditional fund. Performance standards also would not provide this important benefit to investors. An exemption for small entities would defeat the purposes of the amendments for the same reasons.

### VII. Statutory Authority

The Commission is adopting rules 12d1-1, 12d1-2 and 12d1-3 under the authority set forth in sections 6(c), 12(d)(1)(J), and 38(a) of the Act (15 U.S.C. 80a-6(c), 80a-12(d)(1)(J), 80a-37(a)). The Commission is also adopting amendments to Forms N-1A, N-2, N-3, N-4, and N-6 under the authority set forth in sections 6, 7(a), 10 and 19(a) of the Securities Act (15 U.S.C. 77f, 77g(a), 77j, 77s(a)), and sections 8(b), 24(a), 30, and 38(a) of the Act (15 U.S.C. 80a-8(b), 80a-24(a), 80a-29, and 80a-37(a)).

### List of Subjects

#### 17 CFR Part 239

Reporting and recordkeeping requirements, Securities.

#### 17 CFR Parts 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

### Text of Rules and Form Amendments

■ For the reasons set out in the preamble, the Commission is amending Title 17, Chapter II of the Code of Federal Regulations as follows:

### PART 239—FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

■ 1. The authority citation for part 239 continues to read, in part, as follows:

**Authority:** 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77x-3, 77sss, 78c, 78l, 78m, 78n, 78o(d), 78u-5, 78w(a), 78ll(d), 79e, 79f, 79g, 79j, 79l, 79m, 79n, 79q, 79t, 80a-9, 80a-10, 10a-13, 80a-8, 80a-24, 80a-26, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

### PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

■ 2. The authority citation for part 270 is amended by revising the subauthority for § 270.12d1-1 to read as follows:

**Authority:** 15 U.S.C. 80a-1 *et seq.*, 80a-34(d), 80a-37, and 80a-39, unless otherwise noted;

\* \* \* \* \*

Sections 270.12d1-1, 270.12d1-2, and 270.12d1-3 are also issued under 15 U.S.C. 80a-6(c), 80a-12(d)(1)(J), and 80a-37(a).

\* \* \* \* \*

■ 3. Sections 270.12d1-1, 270.12d1-2, and 270.12d1-3 are added to read as follows:

### § 270.12d1-1 Exemptions for investments in money market funds.

(a) *Exemptions for acquisition of money market fund shares.* If the conditions of paragraph (b) of this section are satisfied, notwithstanding sections 12(d)(1)(A), 12(d)(1)(B), 17(a), and 57 of the Act (15 U.S.C. 80a-12(d)(1)(A), 80a-12(d)(1)(B), 80a-17(a), and 80a-56), and § 270.17d-1:

(1) An investment company ("acquiring fund") may purchase and redeem shares issued by a money market fund; and

(2) A money market fund, any principal underwriter thereof, and a broker or a dealer may sell or otherwise dispose of shares issued by the money market fund to an acquiring fund.

(b) Conditions—(1) *Fees.* The acquiring fund pays no sales charge, as defined in rule 2830(b)(8) of the Conduct Rules of the NASD ("sales charge"), or service fee, as defined in rule 2830(b)(9) of the Conduct Rules of the NASD, charged in connection with the purchase, sale, or redemption of securities issued by a money market fund ("service fee"); or the acquiring fund's investment adviser waives its advisory fee in an amount necessary to offset any sales charge or service fee.

(2) *Unregistered money market funds.* If the money market fund is not an investment company registered under the Act:

(i) The acquiring fund reasonably believes that the money market fund satisfies the following conditions as if it were a registered open-end investment company:

(A) Operates in compliance with § 270.2a-7;

(B) Complies with sections 17(a), (d), (e), 18, and 22(e) of the Act (15 U.S.C. 80a-17(a), (d), (e), 80a-18, and 80a-22(e));

(C) Has adopted procedures designed to ensure that it complies with sections 17(a), (d), (e), 18, and 22(e) of the Act (15 U.S.C. 80a-17(a), (d), (e), 80a-18, and 80a-22(e)), periodically reviews and updates those procedures, and maintains books and records describing those procedures;

(D) Maintains the records required by §§ 270.31a-1(b)(1), 270.31a-1(b)(2)(ii),

270.31a-1(b)(2)(iv), and 270.31a-1(b)(9); and

(E) Preserves permanently, the first two years in an easily accessible place, all books and records required to be made under paragraphs (b)(2)(i)(C) and (D) of this section, and makes those records available for examination on request by the Commission or its staff; and

(ii) The adviser to the money market fund is registered with the Commission as an investment adviser under section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3).

*(c) Exemption from certain monitoring and recordkeeping requirements under § 270.17e-1.*

Notwithstanding the requirements of §§ 270.17e-1(b)(3) and 270.17e-1(d)(2), the payment of a commission, fee, or other remuneration to a broker shall be deemed as not exceeding the usual and customary broker's commission for purposes of section 17(e)(2)(A) of the Act if:

(1) The commission, fee, or other remuneration is paid in connection with the sale of securities to or by an acquiring fund;

(2) The broker and the acquiring fund are affiliated persons because each is an affiliated person of the same money market fund; and

(3) The acquiring fund is an affiliated person of the money market fund solely because the acquiring fund owns, controls, or holds with power to vote five percent or more of the outstanding securities of the money market fund.

(d) *Definitions.* (1) *Investment company* includes a company that would be an investment company under section 3(a) of the Act (15 U.S.C. 80a-3(a)) but for the exceptions to that definition provided for in sections 3(c)(1) and 3(c)(7) of the Act (15 U.S.C. 80a-3(c)(1) and 80a-3(c)(7)).

(2) *Money market fund* means:

(i) An open-end management investment company registered under the Act that is regulated as a money market fund under § 270.2a-7; or

(ii) A company that would be an investment company under section 3(a) of the Act (15 U.S.C. 80a-3(a)) but for the exceptions to that definition provided for in sections 3(c)(1) and 3(c)(7) of the Act (15 U.S.C. 80a-3(c)(1) and 80a-3(c)(7)) and that:

(A) Is limited to investing in the types of securities and other investments in which a money market fund may invest under § 270.2a-7; and

(B) Undertakes to comply with all the other requirements of § 270.2a-7, except that, if the company has no board of

directors, the company's investment adviser performs the duties of the board of directors.

**§ 270.12d1-2 Exemptions for investment companies relying on section 12(d)(1)(G) of the Act.**

(a) *Exemption to acquire other securities.* Notwithstanding section 12(d)(1)(G)(i)(II) of the Act (15 U.S.C. 80a-12(d)(1)(G)(i)(II)), a registered open-end investment company or a registered unit investment trust that relies on section 12(d)(1)(G) of the Act (15 U.S.C. 80a-12(d)(1)(G)) to acquire securities issued by another registered investment company that is in the same group of investment companies may acquire, in addition to Government securities and short-term paper:

(1) Securities issued by an investment company, other than securities issued by another registered investment company that is in the same group of investment companies, when the acquisition is in reliance on section 12(d)(1)(A) or 12(d)(1)(F) of the Act (15 U.S.C. 80a-12(d)(1)(A) or 80a-12(d)(1)(F));

(2) Securities (other than securities issued by an investment company); and

(3) Securities issued by a money market fund, when the acquisition is in reliance on § 270.12d1-1.

(b) *Definitions.* For purposes of this section, money market fund has the same meaning as in § 270.12d1-1(d)(2).

(1) Securities issued by an investment company, other than securities issued by another registered investment company that is in the same group of investment companies, when the acquisition is in reliance on section 12(d)(1)(A) or 12(d)(1)(F) of the Act (15 U.S.C. 80a-12(d)(1)(A) or 80a-12(d)(1)(F));

(2) Securities (other than securities issued by an investment company) that relies on section 12(d)(1)(F) of the Act (15 U.S.C. 80a-12(d)(1)(F)) to acquire securities issued by an investment company ("acquired fund") may offer or sell any security it issues through a principal underwriter or otherwise at a public offering price that includes a sales load of more than 1½ percent if any sales charges and service fees charged with respect to the acquiring fund's securities do not exceed the limits set forth in rule 2830 of the Conduct Rules of the NASD applicable to a fund of funds.

(b) *Definitions.* For purposes of this section, the terms *fund of funds*, *sales charge*, and *service fee* have the same meanings as in rule 2830(b) of the Conduct Rules of the NASD.

**PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940**

■ 4. The authority citation for part 274 continues to read in part as follows:

**Authority:** 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, and 80a-29, unless otherwise noted.

\* \* \* \* \*

5. Form N-1A (referenced in §§ 239.15A and 274.11A), Item 3, is amended by adding paragraph (f) to Instruction 3 to read as follows:

**Note:** The text of Form N-1A does not, and this amendment will not, appear in the Code of Federal Regulations.

**Form N-1A**

\* \* \* \* \*

Item 3. Risk/Return Summary: Fee Table

\* \* \* \* \*

*Instructions*

\* \* \* \* \*

*3. Annual Fund Operating Expenses.*

\* \* \* \* \*

(f)(i) If the Fund (unless it is a Feeder Fund) invests in shares of one or more Acquired Funds, add a subcaption to the "Annual Fund Operating Expenses" portion of the table directly above the subcaption titled "Total Annual Fund Operating Expenses." Title the additional subcaption: "Acquired Fund Fees and Expenses." Disclose in the subcaption fees and expenses incurred indirectly by the Fund as a result of investment in shares of one or more Acquired Funds. For purposes of this item, an "Acquired Fund" means any company in which the Fund invests or has invested during the relevant fiscal period that (A) is an investment company or (B) would be an investment company under section 3(a) of the Investment Company Act (15 U.S.C. 80a-3(a)) but for the exceptions to that definition provided for in sections 3(c)(1) and 3(c)(7) of the Investment Company Act (15 U.S.C. 80a-3(c)(1) and 80a-3(c)(7)). If a Fund uses another term in response to other requirements of this Form to refer to Acquired Funds, it may include that term in parentheses following the subcaption title. In the event the fees and expenses incurred indirectly by the Fund as a result of investment in shares of one or more Acquired Funds do not exceed 0.01 percent (one basis point) of average net assets of the Fund, the Fund may include these fees and expenses under the subcaption "Other Expenses" in lieu of this disclosure requirement.

(ii) Determine the "Acquired Fund Fees and Expenses" according to the following formula:

$$AF\text{FE} = \frac{[(F_1/FY) * AI_1 * D_1] + [(F_2/FY) * AI_2 * D_2] + [(F_3/FY) * AI_3 * D_3] + \text{Transaction Fees} + \text{Incentive Allocations}}{\text{Average Net Assets of the Fund}}$$

Where:

AF FE = Acquired Fund fees and expenses;

F<sub>1</sub>, F<sub>2</sub>, F<sub>3</sub>, . . . = Total annual operating expense ratio for each Acquired Fund;

FY = Number of days in the relevant fiscal year.

AI<sub>1</sub>, AI<sub>2</sub>, AI<sub>3</sub>, . . . = Average invested balance in each Acquired Fund;

D<sub>1</sub>, D<sub>2</sub>, D<sub>3</sub>, . . . = Number of days invested in each Acquired Fund; and

“Transaction Fees” = The total amount of sales loads, redemption fees, or other transaction fees paid by the Fund in connection with acquiring or disposing of shares in any Acquired Funds during the most recent fiscal year.

“Incentive Allocations” = Any allocation of capital from the Acquiring Fund to the adviser of the Acquired Fund (or its affiliate) based on a percentage of the Acquiring Fund’s income, capital gains and/or appreciation in the Acquired Fund.

(iii) Calculate the average net assets of the Fund for the most recent fiscal year, as provided in Item 8(a) (see Instruction 4 to Item 8(a)).

(iv) The total annual operating expense ratio used for purposes of this calculation (F<sub>1</sub>) is the annualized ratio of operating expenses to average net assets for the Acquired Fund’s most recent fiscal period as disclosed in the Acquired Fund’s most recent shareholder report. If the ratio of expenses to average net assets is not included in the most recent shareholder report or the Acquired Fund is a newly formed fund that has not provided a shareholder report, then the ratio of expenses to average net assets of the Acquired Fund is the ratio of total annual operating expenses to average annual net assets of the Acquired Fund for its most recent fiscal period as disclosed in the most recent communication from the Acquired Fund to the Fund. For purposes of this instruction: (i) Acquired Fund expenses include increases resulting from brokerage service and expense offset arrangements and reductions resulting

from fee waivers or reimbursements by the Acquired Funds’ investment advisers or sponsors; and (ii) Acquired Fund expenses do not include expenses (i.e., performance fees) that are incurred solely upon the realization and/or distribution of a gain. If an Acquired Fund has no operating history, include in the Acquired Funds’ expenses any fees payable to the Acquired Fund’s investment adviser or its affiliates stated in the Acquired Fund’s registration statement, offering memorandum or other similar communication without giving effect to any performance.

(v) To determine the average invested balance (AI<sub>1</sub>), the numerator is the sum of the amount initially invested in an Acquired Fund during the most recent fiscal year (if the investment was held at the end of the previous fiscal year, use the amount invested as of the end of the previous fiscal year) and the amounts invested in the Acquired Fund no less frequently than monthly during the period the investment is held by the Fund (if the investment was held through the end of the fiscal year, use each month-end through and including the fiscal year-end). Divide the numerator by the number of measurement points included in the calculation of the numerator (i.e., if an investment is made during the fiscal year and held for 3 succeeding months, the denominator would be 4).

(vi) A New Fund should base the Acquired Fund fees and expenses on assumptions as to the specific Acquired Funds in which the New Fund expects to invest. Disclose in a footnote to the table that Acquired Fund fees and expenses are based on estimated amounts for the current fiscal year.

(vii) The Fund may clarify in a footnote to the fee table that the total annual fund operating expenses under Item 3 do not correlate to the ratio of expenses to average net assets given in response to Item 8, which reflects the operating expenses of the Fund and does not include Acquired Fund fees and expenses.

\* \* \* \* \*  
6. Form N–2 (referenced in §§ 239.14 and 274.11a–1), Item 3, paragraph 1, is amended by:

a. Redesignating Instruction 10 titled “Example” as Instruction 11; and

b. Adding new Instruction 10. The addition reads as follows:

**Note:** The text of Form N–2 does not, and this amendment will not, appear in the Code of Federal Regulations.

**FORM N–2**

\* \* \* \* \*

Item 3. Fee Table and Synopsis

1. \* \* \*

*Instructions:*

\* \* \* \* \*

10. a. If the Registrant invests, or intends to invest based upon the anticipated net proceeds of the present offering, in shares of one or more “Acquired Funds,” add a subcaption to the “Annual Expenses” portion of the table directly above the subcaption titled “Total Annual Expenses.” Title the additional subcaption: “Acquired Fund Fees and Expenses.” Disclose in the subcaption fees and expenses incurred indirectly by the Registrant as a result of investment in shares of one or more Acquired Funds. For purposes of this item, an “Acquired Fund” means any company in which the Registrant invests or intends to invest (A) that is an investment company or (B) that would be an investment company under section 3(a) of the 1940 Act (15 U.S.C. 80a–3(a)) but for the exceptions to that definition provided for in sections 3(c)(1) and 3(c)(7) of the 1940 Act (15 U.S.C. 80a–3(c)(1) and 80a–3(c)(7)). If a Registrant uses another term in response to other requirements of this Form to refer to Acquired Funds, it may include that term in parentheses following the subcaption title. In the event the fees and expenses incurred indirectly by the Registrant as a result of investment in shares of one or more Acquired Funds do not exceed 0.01 percent (one basis point) of average net assets of the Registrant, the Registrant may include these fees and expenses under the subcaption “Other Expenses” in lieu of this disclosure requirement.

b. Determine the “Acquired Fund Fees and Expenses” according to the following formula:

$$AF\text{FE} = \frac{[(F_1/FY) * AI_1 * D_1] + [(F_2/FY) * AI_2 * D_2] + [(F_3/FY) * AI_3 * D_3] + \text{Transaction Fees} + \text{Incentive Allocations}}{\text{Average Net Assets of the Registrant}}$$

Where:

AFFE = Acquired Fund fees and expenses;  
 F1, F2, F3, . . . = Total annual operating expense ratio for each Acquired Fund;  
 FY = Number of days in the relevant fiscal year.  
 AI<sub>1</sub>, AI<sub>2</sub>, AI<sub>3</sub>, . . . = Average invested balance in each Acquired Fund;  
 D1, D2, D3, . . . = Number of days invested in each Acquired Fund;  
 "Transaction Fees" = The total amount of sales loads, redemption fees, or other transaction fees paid by the Registrant in connection with acquiring or disposing of shares in any Acquired Funds during the most recent fiscal year; and  
 "Incentive Allocations" = Any allocation of capital from the Acquiring Fund to the adviser of the Acquired Fund (or its affiliate) based on a percentage of the Acquiring Fund's income, capital gains and/or appreciation in the Acquired Fund.

c. Calculate the average net assets of the Registrant for the most recent fiscal year, as provided in Item 4.1 (see Instruction 15 to Item 4.1) and include the anticipated net proceeds of the present offering.

d. The total annual operating expense ratio used for purposes of this calculation (F<sub>i</sub>) is the annualized ratio of operating expenses to average net assets for the Acquired Fund's most recent fiscal period as disclosed in the Acquired Fund's most recent shareholder report. If the ratio of expenses to average net assets is not included in the most recent shareholder report or the Acquired Fund is a newly formed fund that has not provided a shareholder report, then the ratio of expenses to average net assets of the Acquired Fund is the ratio of total annual operating expenses to average annual net assets of the Acquired Fund for its most recent fiscal period as disclosed in the most recent communication from the Acquired Fund to the Registrant. If the Registrant has a written fee agreement with the Acquired Fund that would affect the ratio of expenses to average net assets as disclosed in the Acquired Fund's most recent shareholder report, the Registrant should determine the ratio of expenses to average net assets for the Acquired Fund's most recent fiscal period using the written fee agreement. For purposes of this instruction: (i) Acquired Fund expenses include increases resulting from brokerage service and expense offset arrangements and reductions resulting from fee waivers or reimbursements by the Acquired Funds'

investment advisers or sponsors; and (ii) Acquired Fund expenses do not include any expenses (i.e., performance fees) that are calculated solely upon the realization and/or distribution of gains, or the sum of the realization and/or distribution of gains and unrealized appreciation of assets distributed in-kind. If an Acquired Fund has no operating history, include in the Acquired Funds' expenses any fees payable to the Acquired Fund's investment adviser or its affiliates stated in the Acquired Fund's registration statement, offering memorandum or other similar communication without giving effect to any performance.

e. If a Registrant has made investments in the most recent fiscal year, to determine the average invested balance (AI<sub>i</sub>), the numerator is the sum of the amount initially invested in an Acquired Fund during the most recent fiscal year (if the investment was held at the end of the previous fiscal year, use the amount invested as of the end of the previous fiscal year) and the amounts invested in the Acquired Fund no less frequently than monthly during the period the investment is held by the Registrant (if the investment was held through the end of the fiscal year, use each month-end through and including the fiscal year-end). Divide the numerator by the number of measurement points included in the calculation of the numerator (i.e., if an investment is made during the fiscal year and held for 3 succeeding months, the denominator would be 4).

f. For investments based upon the anticipated net proceeds from the present offering, base the "Acquired Fund Fees and Expenses" on: (i) Assumptions about specific funds in which the Registrant expects to invest, (ii) estimates of the amount of assets the Registrant expects to invest in each of those Acquired Funds, and (iii) an assumption that the investment was held for all of the Registrant's most recent fiscal year and was subject to the Acquired Funds' fees and expenses for that year. Disclose in a footnote to the table that Acquired Fund fees and expenses are based on estimated amounts for the current fiscal year.

g. If an Acquired Fund charges an Incentive Allocation or any other fee based on income, capital gains and/or appreciation (i.e., performance fee), the Registrant must include a footnote to the "Acquired Fund Fees and Expenses" subcaption that: (i) Discloses the typical Incentive Allocation or such other fee (expressed as a percentage) to be paid to the investment advisers of the Acquired Funds (or an affiliate); (ii) discloses that Acquired Funds' fees and expenses are

based on historic fees and expenses; and (iii) states that future Acquired Funds' fees and expenses may be substantially higher or lower because certain fees are based on the performance of the Acquired Funds, which may fluctuate over time.

h. If the Registrant is a Feeder Fund, reflect the aggregate expenses of the Feeder Fund and the Master Fund in the "Acquired Fund Fees and Expenses." The aggregate expenses of the Master-Feeder Fund must include the fees and expenses incurred indirectly by the Feeder Fund as a result of the Master Fund's investment in shares of one or more companies (A) that are investment companies or (B) that would be investment companies under section 3(a) of the 1940 Act (15 U.S.C. 80a-3(a)) but for the exceptions to that definition provided for in sections 3(c)(1) and 3(c)(7) of the 1940 Act (15 U.S.C. 80a-3(c)(1) and 80a-3(c)(7)). For purposes of this instruction, a "Master-Feeder Fund" means a two-tiered arrangement in which one or more investment companies registered under the 1940 Act (each a "Feeder Fund") holds shares of a single management investment company registered under the 1940 Act (the "Master Fund") in accordance with section 12(d)(1)(E) of the 1940 Act [15 U.S.C. 80a-12(d)(1)(E)].

i. The Registrant may clarify in a footnote to the fee table that the total annual expenses item under Item 3.1 is different from the ratio of expenses to average net assets given in response to Item 4.1, which reflects the operating expenses of the Registrant and does not include Acquired Fund fees and expenses.

\* \* \* \* \*  
 7. Form N-3 (referenced in §§ 239.17a and 274.11b), Item 3(a), is amended by:

a. In Instruction 16(a), revising the phrase in the third sentence "Instructions 18(b), 19(e) and 19(f)" to read "Instructions 18(b), 19(f), 20(e), and 20(f)";

b. Redesignating Instruction 19 titled "Example" as Instruction 20; and

c. Adding new Instruction 19.

The addition reads as follows:

**Note:** The text of Form N-3 does not, and this amendment will not, appear in the Code of Federal Regulations.

**FORM N-3**

\* \* \* \* \*

Item 3. Synopsis or Highlights

(a) \* \* \*

*Instructions:*

\* \* \* \* \*

19. (a) If the Registrant invests in shares of one or more Acquired Funds,

add a subcaption to the "Annual Expenses" portion of the table directly above the subcaption titled "Total Annual Expenses." Title the additional subcaption: "Acquired Fund Fees and Expenses." Disclose in the subcaption fees and expenses incurred indirectly by the Registrant as a result of investment in shares of one or more Acquired Funds. For purposes of this Item, an "Acquired Fund" means any company in which the Fund invests that (i) is an

investment company or (ii) would be an investment company under section 3(a) of the 1940 Act (15 U.S.C. 80a-3(a)) but for the exceptions to that definition provided for in sections 3(c)(1) and 3(c)(7) of the 1940 Act (15 U.S.C. 80a-3(c)(1) and 80a-3(c)(7)). If a Registrant uses another term in response to other requirements of this Form to refer to Acquired Funds, it may include that term in parentheses following the subcaption title. In the event the fees

and expenses incurred indirectly by the Registrant as a result of investment in shares of one or more Acquired Funds do not exceed 0.01 percent (one basis point) of average net assets of the Registrant, the Registrant may include these fees and expenses under the subcaption "Other Expenses" in lieu of this disclosure requirement.

(b) Determine the "Acquired Fund Fees and Expenses" according to the following formula:

$$AFFE = \frac{[(F_1/FY) * AI_1 * D_1] + [(F_2/FY) * AI_2 * D_2] + [(F_3/FY) * AI_3 * D_3] + \text{Transaction Fees}}{\text{Average Net Assets of the Fund}}$$

Where:

AFFE = Acquired Fund fees and expenses;

F<sub>1</sub>, F<sub>2</sub>, F<sub>3</sub>, ... = Total annual operating expense ratio for each Acquired Fund;

FY = Number of days in the relevant fiscal year.

AI<sub>1</sub>, AI<sub>2</sub>, AI<sub>3</sub>, ... = Average invested balance in each Acquired Fund;

D<sub>1</sub>, D<sub>2</sub>, D<sub>3</sub>, ... = Number of days invested in each Acquired Fund; and

"Transaction Fees" = The total amount of sales loads, redemption fees, or other transaction fees paid by the Registrant in connection with acquiring or disposing of shares in any Acquired Funds during the most recent fiscal year.

(c) Calculate the average net assets of the Registrant for the most recent fiscal year, as provided in Item 4(a) (see Instruction 10 to Item 4(a)).

(d) The total annual operating expense ratio used for purposes of this calculation (F<sub>i</sub>) is the annualized ratio of operating expenses to average net assets for the Acquired Fund's most recent fiscal period as disclosed in the Acquired Fund's most recent shareholder report. If the ratio of expenses to average net assets is not included in the most recent shareholder report or the Acquired Fund is a newly formed fund that has not provided a shareholder report, then the ratio of expenses to average net assets of the Acquired Fund is the ratio of total annual operating expenses to average annual net assets of the Acquired Fund for its most recent fiscal period as disclosed in the most recent communication from the Acquired Fund to the Registrant. For purposes of this instruction, Acquired Fund expenses include increases resulting from brokerage service and expense offset arrangements and reductions resulting from fee waivers or reimbursements by

the Acquired Funds' investment advisers or sponsors.

(e) To determine the average invested balance (AI<sub>i</sub>), the numerator is the sum of the amount initially invested in an Acquired Fund during the most recent fiscal year (if the investment was held at the end of the previous fiscal year, use the amount invested as of the end of the previous fiscal year) and the amounts invested in the Acquired Fund no less frequently than monthly during the period the investment is held by the Registrant (if the investment was held through the end of the fiscal year, use each month-end through and including the fiscal year-end). Divide the numerator by the number of measurement points included in the calculation of the numerator (i.e., if an investment is made during the fiscal year and held for 3 succeeding months, the denominator would be 4).

(f) A New Registrant should base the "Acquired Fund Fees and Expenses" on assumptions as to the specific Acquired Funds in which the New Registrant expects to invest. Disclose in a footnote to the table that Acquired Fund fees and expenses are based on estimated amounts for the current fiscal year.

(g) The Registrant may clarify in a footnote to the fee table that the total annual expenses under Item 3 are different from the ratio of expenses to average net assets given in response to Item 4, which reflects the operating expenses of the Registrant and does not include Acquired Fund fees and expenses.

8. Form N-4 (referenced in §§ 239.17b and 274.11c), Item 3, is amended by adding a sentence at the end of Instruction 17(a) to read as follows:

**Note:** The text of Form N-4 does not, and this amendment will not, appear in the Code of Federal Regulations.

**Form N-4**

\* \* \* \* \*

Item 3. Synopsis

\* \* \* \* \*

*Instructions:*

\* \* \* \* \*

17. (a) \* \* \* If any Portfolio Company invests in shares of one or more Acquired Funds, "Total Annual [Portfolio Company] Operating Expenses" for the Portfolio Company must also include fees and expenses incurred indirectly by the Portfolio Company as a result of investment in shares of one or more Acquired Funds, calculated in accordance with Instruction 3(f) to Item 3 of Form N-1A (17 CFR 239.15A; 17 CFR 274.11A). For purposes of this paragraph, an Acquired Fund means any company in which the Portfolio Company invests that (i) is an investment company or (ii) would be an investment company under section 3(a) of the 1940 Act (15 U.S.C. 80a-3(a)) but for the exceptions to that definition provided for in sections 3(c)(1) and 3(c)(7) of the 1940 Act (15 U.S.C. 80a-3(c)(1) and 80a-3(c)(7)).

\* \* \* \* \*

9. Form N-6 (referenced in §§ 239.17c and 274.11d), Item 3, is amended by adding a sentence at the end of Instruction 4(b) to read as follows:

**Note:** The text of Form N-6 does not, and this amendment will not, appear in the Code of Federal Regulations.

**Form N-6**

\* \* \* \* \*

Item 3. Risk/Benefit Summary: Fee Table

\* \* \* \* \*

*Instructions:*

\* \* \* \* \*

4. Total Annual [Portfolio Company] Operating Expenses.

\* \* \* \* \*

(b) \* \* \* If any Portfolio Company invests in shares of one or more Acquired Funds, "Total Annual [Portfolio Company] Operating Expenses" for the Portfolio Company must also include fees and expenses incurred indirectly by the Portfolio Company as a result of investment in

shares of one or more Acquired Funds, calculated in accordance with Instruction 3(f) to Item 3 of Form N-1A (17 CFR 239.15A; 17 CFR 274.11A). For purposes of this paragraph, an Acquired Fund means any company in which the Portfolio Company invests that (i) is an investment company or (ii) would be an investment company under section 3(a) of the Investment Company Act (15 U.S.C. 80a-3(a)) but for the exceptions to that definition provided for in

sections 3(c)(1) and 3(c)(7) of the Investment Company Act (15 U.S.C. 80a-3(c)(1) and 80a-3(c)(7)).

\* \* \* \* \*

By the Commission.

Dated: June 20, 2006.

Jill M. Peterson,

Assistant Secretary.

[FR Doc. 06-5650 Filed 6-26-06; 8:45 am]

BILLING CODE 8010-01-P