



# Federal Register

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**Wednesday,  
October 8, 2003**

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**Part III**

## **Securities and Exchange Commission**

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**17 CFR Parts 239, 274, and 275  
Fund of Funds Investments; Proposed  
Rule**

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Parts 239, 274, and 275

[Release Nos. 33-8297; IC-26198; File No. S7-18-03]

RIN 3235-A130

### Fund of Funds Investments

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rules.

**SUMMARY:** The Commission is proposing three new rules under the Investment Company Act of 1940 that address the ability of an investment company to acquire shares of another investment company. Section 12(d)(1) of the Act prohibits, subject to certain exceptions, so-called “fund of funds” arrangements, in which one investment company invests in the shares of another. The proposed rules would broaden the ability of an investment company to invest in shares of another investment company consistent with the protection of investors and the purposes of the Act. The Commission also is proposing amendments to forms used by investment companies to register under the Investment Company Act and offer their shares under the Securities Act of 1933. The proposed amendments would 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.

**DATES:** Comments must be received by December 3, 2003.

**ADDRESSES:** To help us process and review your comments more efficiently, comments should be sent by hard copy or e-mail, but not by both methods. Comments sent by hard copy should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549-0609. Comments also may be submitted electronically to the following E-mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All comment letters should refer to File No. S7-18-03; this file number should be included on the subject line if E-mail is used. Comment letters will be available for public inspection and copying in the Commission’s Public Reference Room, 450 5th Street, NW., Washington, DC 20549. Electronically submitted comment letters will be posted on the Commission’s Internet Web site (<http://www.sec.gov>).<sup>1</sup>

### FOR FURTHER INFORMATION CONTACT:

Penelope W. Saltzman, Senior Counsel, or C. Hunter Jones, Assistant Director, Office of Regulatory Policy, (202) 942-0690, Division of Investment Management, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549-0506.

**SUPPLEMENTARY INFORMATION:** The Securities and Exchange Commission (the “Commission”) today is proposing for public comment new rules 12d1-1 [17 CFR 270.12d1-1], 12d1-2 [17 CFR 270.12d1-2], and 12d1-3 [17 CFR 270.12d1-3] under the Investment Company Act of 1940 [15 U.S.C. 80a] (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”). We also are proposing amendments to Forms N-1A [17 CFR 239.15A; 17 CFR 274.11A], N-2 [17 CFR 239.14; 17 CFR 274.11a-1], N-3 [17 CFR 239.17a; 17 CFR 274.11b], N-4 [17 CFR 239.17b; 17 CFR 274.11c], and N-6 [17 CFR 239.17c; 17 CFR 274.11d] to require that prospectuses of funds of funds disclose all of the expenses investors in the fund will bear, including those of any acquired funds. 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 [15 U.S.C. 77a] (“Securities Act”). Form N-3 is the registration form used by separate accounts that are organized as management investment companies and offer variable annuity contracts to register under the Act and to offer their shares under the Securities Act. Forms N-4 and N-6 are the forms used by separate accounts organized as unit investment trusts (“UITs”) that offer variable annuity and variable life insurance contracts, respectively, to register under the Act and to offer their shares under the Securities Act.

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### I. Background

Today, the federal securities laws restrict substantially the ability of a fund to invest in shares of other funds. Before the enactment of the Investment Company Act in 1940, however, a fund was free to purchase an unlimited number of shares of another fund. These “fund of funds” arrangements yielded numerous abuses, which were catalogued in the Commission’s study of funds that preceded the Act (“Investment Trust Study”).<sup>2</sup>

Using a relatively small amount of money, individuals could acquire control of a fund and use its assets to acquire control of the assets of another fund, which, in turn, could use its assets to control a third fund.<sup>3</sup> As a result, a few individuals effectively could control millions of dollars in shareholder assets invested in various acquired funds. These “pyramiding” schemes were used to enrich the individuals at the expense of fund shareholders in a number of ways. In some cases, controlling individuals caused the acquired funds to purchase securities in companies in which the

<sup>2</sup> Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, pt. 3, ch. 7, H.R. Doc. No. 136, 77th Cong., 1st Sess. 2721-95 (1941).

<sup>3</sup> See Investment Trust Study, *supra* note 2, pt. 3, ch. 4, at 1031-39 and 1040-41, nn. 58-59 (discussing how individuals and other investors were able to make relatively small investments and gain control of funds); ch. 7, at 2742-50.

<sup>1</sup> We do not edit personal, identifying information, such as names or E-mail addresses,

individuals had an interest. In other cases, these individuals caused funds to direct underwriting and brokerage business to broker-dealers they controlled—often on terms favorable to the broker-dealer. Controlling persons also profited when fund shareholders paid excessive charges due to duplicative fees at the acquiring and acquired fund levels.<sup>4</sup>

The complex structures that resulted from pyramiding created additional problems for shareholders. These structures permitted acquiring funds to circumvent investment restrictions and limitations, and made it impossible for shareholders to understand who really controlled the fund or the true value of their investments.<sup>5</sup> A fund shareholder might know that he owned shares in a fund that invested in equity securities of large companies without understanding that the large companies were large funds that exposed him to substantial risks associated with smaller issuers, foreign currencies, or interest rates.<sup>6</sup>

In response to these findings in the Investment Trust Study, Congress included in the Act a provision designed to restrict fund of funds arrangements. As originally enacted, section 12(d)(1) prohibited a registered investment company (and any companies it controlled) from purchasing more than five percent of the outstanding shares of any fund that concentrated its investments in a particular industry, or more than three percent of the shares of any other type of fund.<sup>7</sup>

Section 12(d)(1) proved flawed, however, because it did not prevent *unregistered* investment companies from acquiring the securities of *registered* funds. In the 1960s, Fund of Funds, Ltd., an unregistered fund operated in Geneva, Switzerland, began to exploit that flaw by marketing to members of the U.S. military stationed overseas shares of foreign investment companies that had controlling interests in several registered U.S. funds.<sup>8</sup> Fund of Funds, Ltd. engaged in many of the

abusive activities identified in the Investment Trust Study. These included charging duplicative advisory fees at the acquiring and acquired fund levels, providing sales loads to an affiliated broker for each investment the acquiring fund made in an acquired fund, and directing brokerage business to an affiliate of the fund of funds (which then rebated half the commission).<sup>9</sup> In addition, Fund of Funds, Ltd. could exert undue influence on the management of acquired funds by threatening advisers to those funds with large redemptions.<sup>10</sup>

In 1970, Congress revisited section 12(d)(1) of the Act. Among other things, it tightened the restrictions on funds of funds and extended them to unregistered funds that invest in registered funds.<sup>11</sup> Today, funds are subject to two sets of prohibitions. First, 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 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>12</sup>

Second, 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; or
- Together with other funds (and companies they control) own more than ten percent of the acquired fund's voting securities.<sup>13</sup>

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, such as Fund of Funds, Ltd. Together, 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 recognized that these restrictions would have the effect of preventing legitimate fund of funds arrangements and has, over the years, created three exceptions under which different types of fund of funds arrangements are permitted today:

**Conduit Arrangements.** The Act permits arrangements under which a registered fund invests *all* of its assets in shares of one other fund so that the acquiring fund is, in effect, a conduit through which investors may access the acquired fund.<sup>14</sup> The exception currently provided in section 12(d)(1)(E) was originally designed to preserve the arrangements under which periodic payment plan certificates were issued.<sup>15</sup> Today, this section is relied upon by most insurance company separate accounts, which are organized as UITs,<sup>16</sup> and invest the proceeds from the sale of interests in variable annuity and variable life insurance contracts in shares of a mutual fund.<sup>17</sup> This exemption also is used by “master-feeder funds”—arrangements in which two or more funds with identical investment objectives pool their assets by investing in a single fund with the same investment objective. Investors purchase securities in the “feeder”

<sup>14</sup> See 15 U.S.C. 80a–12(d)(1)(E).

<sup>15</sup> The exception for periodic payment plan arrangements originally was set forth in section 12(d)(1)(B). Section 12(d)(1)(E) was added by the 1970 Amendments. See S. Rep. No. 184, *supra* note 11, at 31; 1970 Amendments, *supra* note 11, § 7 (codified at 15 U.S.C. 80a–12(d)(1)(E)). Section 12(d)(1)(E) permits a fund's acquisition of securities issued by another fund provided that (i) the acquiring fund's depositor or principal underwriter is a broker or dealer registered under the Securities Exchange Act of 1934, (or a person the broker-dealer controls), (ii) the security is the only investment security the acquiring fund holds (or the securities are the only investment securities the acquiring fund holds if it is a registered UIT that issues two or more classes or series of securities, each of which provides for the accumulation of shares of a different fund), and (iii) the acquiring fund is obligated (a) to seek instructions from its shareholders with regard to voting the acquired fund's securities or to vote the acquired fund's shares in the same proportion as the vote of all other acquired fund shareholders, and (b) if unregistered, to obtain Commission approval before substituting the investment security.

<sup>16</sup> The Act defines a “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>17</sup> See Securities and Exchange Commission, Protecting Investors: A Half Century of Investment Company Regulation 373–74 (1992) (“1992 Study”); Request for Comments on Issues Arising Under the Investment Company Act of 1940 Relating to Flexible Premium Variable Life Insurance, Investment Company Act Release No. 13632 (Nov. 23, 1983) [48 FR 54043 (Nov. 30, 1983)].

<sup>4</sup> See Investment Trust Study, *supra* note 2, pt. 3, ch. 7, at 2725–39, 2760–75.

<sup>5</sup> See *id.* at 2776–77 (discussing examples of fund investment policy changes that conformed to management interests), 2781–82 (discussing examples of management policies that resulted in confusing or misleading asset valuations).

<sup>6</sup> See *id.* at 2721–95.

<sup>7</sup> See Pub. L. No. 76–768, 54 Stat. 789, 809–10 § 12(d)(1) (1940) (codified at 15 U.S.C. 80a–12(d)(1) (1940)).

<sup>8</sup> See H.R. Rep. No. 1382, 91st Cong., 2d Sess., 23 (1970) (“H.R. Rep. No. 1382”); Charles Raw, *et al.*, Do You Sincerely Want to be Rich? 61–66 (1971). Fund of Funds, Ltd. was incorporated in Ontario, Canada. See Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess., 312–24 (1966) (“1966 Study”).

<sup>9</sup> See *Arthur Lipper Corp. et al. v. SEC*, Securities Exchange Act Release No. 11773, 46 S.E.C. 78 (Oct. 24, 1975), *sanction modified*, 547 F.2d 171 (2d Cir. 1976).

<sup>10</sup> See 1966 Study, *supra* note 8, at 315–16.

<sup>11</sup> See Pub. L. No. 91–547, 84 Stat. 1413, 1417 § 7 (1970) (“1970 Amendments”) (codified at 15 U.S.C. 80a–12(d)(1)(A)). See also Sen. Rep. No. 184, 91st Cong., 1st Sess., at 31 (1969) (“Sen. Rep. No. 184”).

<sup>12</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.

<sup>13</sup> See 15 U.S.C. 80a–12(d)(1)(B).

fund, which is an open-end fund and a conduit to the "master" fund.<sup>18</sup>

**Unaffiliated Fund of Funds Arrangements.** The Act also permits a registered fund to take small positions in an unlimited number of other funds (an "unaffiliated fund of funds").<sup>19</sup> 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 securities;<sup>20</sup> cannot charge a sales load greater than 1½ percent;<sup>21</sup> is restricted in its ability to redeem shares of the acquired fund;<sup>22</sup> and is unable to use its voting power to influence the outcome of shareholder votes held by the acquired fund.<sup>23</sup> The exception was designed to give limited relief to fund of funds arrangements in existence in 1970 when section 12(d)(1) was amended, subject to restrictions designed to prevent abuses.<sup>24</sup>

**Affiliated Fund of Funds Arrangements.** The Act also permits a fund to invest in one or more funds in the same fund complex. Enacted as part of the National Securities Markets Improvement Act of 1996 ("NSMIA"),<sup>25</sup>

<sup>18</sup> See H.R. Rep. No. 622, 104th Cong., 2d Sess., at 41 (1996) ("H.R. Rep. No. 622"); Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master Feeder Funds; Voting on Distribution Plans; Final Rules and Proposed Rule, Investment Company Act Release No. 20915 (Feb. 23, 1995) [60 FR 11876, 11876-77 (Mar. 2, 1995)]; Division of Investment Management, Securities and Exchange Commission, Hub and Spoke Funds: A Report Prepared by the Division of Investment Management, submitted with letter to the Honorable John D. Dingell, Chairman, Committee on Energy and Commerce, U.S. House of Representatives from Richard C. Breiden, Chairman, Securities and Exchange Commission (Apr. 15, 1992), available in LEXIS, Fedsec library, Noact File.

<sup>19</sup> See 15 U.S.C. 80a-12(d)(1)(F).

<sup>20</sup> A registered fund relying on section 12(d)(1)(F) may acquire securities issued by another fund if, immediately after acquiring the securities, not more than three percent of the total outstanding stock of the acquired fund is owned by the acquiring fund and all its affiliates. See 15 U.S.C. 80a-12(d)(1)(F)(i). Section 12(d)(1)(F) does not limit acquiring fund investments in securities other than those issued by other funds.

<sup>21</sup> A fund relying on section 12(d)(1)(F) may not offer or sell (or propose to offer or sell through a principal underwriter) a security it issues at a public offering price that includes a sales load of more than 1½ percent. See 15 U.S.C. 80a-12(d)(1)(F)(ii).

<sup>22</sup> A fund whose shares are acquired pursuant to section 12(d)(1)(F) is not obligated to redeem more than 1 percent of those securities during any period of less than 30 days. 15 U.S.C. 80a-12(d)(1)(F).

<sup>23</sup> Section 12(d)(1)(F), by reference to section 12(d)(1)(E), 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. *Id.*

<sup>24</sup> See H.R. Rep. No. 1382, *supra* note 8, at 11.

<sup>25</sup> Pub. L. No. 104-290, 110 Stat. 3416 (1996).

section 12(d)(1)(G) permits a registered open-end fund or UIT 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."<sup>26</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>27</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>28</sup> and overall distribution expenses are limited (to prevent excessive sales loads).<sup>29</sup> Under this provision, which codified Commission exemptive orders,<sup>30</sup> several

<sup>26</sup> See 15 U.S.C. 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>27</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>28</sup> See 15 U.S.C. 80a-12(d)(1)(G)(i)(IV).

<sup>29</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 acquired fund, or (ii) the aggregate distribution-related fees (or loads) 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)(2), (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 front-end and deferred sales charge that can be charged by the acquiring fund, the acquired fund, and both in combination cannot exceed 8.5 percent of the offering price of the shares. 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 the fund; 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)(2)(A), (B).

<sup>30</sup> See Vanguard STAR Fund, Investment Company Act Release No. 21372 (Sept. 22, 1995) [60 FR 50656 (Sept. 29, 1995)] (notice), Investment Company Act Release No. 21426 (Oct. 18, 1995) (order) (revising conditions on the 1985 Vanguard Order); T. Rowe Price Spectrum Fund, Investment Company Act Release No. 21371 (Sept. 22, 1995)

large fund complexes offer a fund of funds, which allocates and periodically reallocates its assets among funds in the complex.<sup>31</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>32</sup> In 1996, when Congress added section 12(d)(1)(G), it gave us specific authority to exempt any person, security, or transaction, or any class or classes of transactions, from section 12(d)(1) if the exemption is consistent with the public interest and the protection of investors.<sup>33</sup> The House Report accompanying NSMIA urged the Commission to use the additional exemptive authority under section 12(d)(1)(J) "in a progressive way as the fund of funds concept continues to evolve over time."<sup>34</sup>

Today we are proposing three new rules. Two of these provide exemptions

[60 FR 50654 (Sept. 29, 1995)] (notice), Investment Company Act Release No. 21425 (Oct. 18, 1995) (order) (revising conditions on the 1989 T. Rowe Price Order); T. Rowe Price Spectrum Fund, Investment Company Act Release No. 17198 (Oct. 31, 1989) [54 FR 47010 (Nov. 8, 1989)] (notice), Investment Company Act Release No. 17242 (Nov. 29, 1989) (order) ("1989 T. Rowe Price Order"); Vanguard Special Tax-Advanced Retirement Fund, Investment Company Act Release No. 14153 (Sept. 12, 1984) [49 FR 36582 (Sept. 18, 1984)] (notice), Investment Company Act Release No. 14361 (Feb. 7, 1985) (order) ("1985 Vanguard Order").

<sup>31</sup> See, e.g., T. Rowe Price, Retirement Funds, Prospectus 1-4 (Mar. 14, 2003).

<sup>32</sup> 15 U.S.C. 80a-6(c). Section 6(c) provides that "[t]he Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

<sup>33</sup> See NSMIA, *supra* note 25, § 202 (codified at 15 U.S.C. 80a-12(d)(1)(J)). Congress added section 12(d)(1)(J) to resolve questions regarding the scope of our authority under section 6(c). See 1985 Vanguard Order, *supra* note 30, dissenting opinion of Commissioners Treadway and Peters (concluding that applicants failed to establish an adequate record on which Commission could find exemption from section 12(d)(1)(A) to meet the standards of section 6(c) of the Act).

<sup>34</sup> H.R. Rep. No. 622, *supra* note 18, at 44-45. The House Report explained that, in exercising its exemptive authority, the Commission should consider factors that relate to the protection of investors, including the extent to which a proposed arrangement is subject to conditions that are designed to address conflicts of interest and overreaching by a participant in the arrangement, so as to avoid the abuses that gave rise to the initial adoption of the Act's restrictions against funds investing in other funds. See *id.* at 45.

in addition to the statutory exceptions to the fund of funds limits. The third provides an exemption from a statutory condition for a fund of funds arrangement. These rules would codify and expand upon a number of exemptive orders we have issued that permit funds to invest in other funds. We also are proposing amendments to Forms N-1A, N-2, N-3, N-4, and N-6 that will require funds of funds to disclose in their prospectuses the expenses of acquired funds, which investors in a fund of funds will bear indirectly.

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

We are proposing a new rule that would permit funds to invest in shares of money market funds. Rule 12d1-1 would 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.<sup>35</sup> Since 1982, we have issued more than 80 exemptive orders permitting these types of arrangements.<sup>36</sup> Funds have represented that use of a money market fund may be expected to achieve greater efficiencies, reduce fund management expenses, and increase returns.<sup>37</sup>

<sup>35</sup> A fund may have uninvested cash from new purchases of shares by investors, receipt of dividends and interest from portfolio investments, and matured investments, as well as cash collateral from securities lending activities. The proposed rule would permit a fund to invest in one or more money market funds.

<sup>36</sup> See, e.g., Diamond Hill Funds, Investment Company Act Release No. 26058 (May 28, 2003) [68 FR 33213 (June 3, 2003)] (notice); Investment Company Act Release No. 26079 (June 24, 2003) (order); SEI Index Funds, Investment Company Act Release No. 26008 (Apr. 22, 2003) [68 FR 22423 (Apr. 28, 2003)] (notice); Investment Company Act Release No. 26048 (May 19, 2003) (order). These orders contain a number of conditions, including: (i) Shares of the acquired money market fund will not be subject to sales loads, distribution-related fees, or service fees, or if they are, the acquiring fund's adviser will waive its advisory fee in an amount to offset the amount of fees incurred by the acquiring fund; (ii) before approving any advisory contract for the acquiring fund, its board of directors, including a majority of directors who are not interested persons under section 2(a)(19) of the Act [15 U.S.C. 80a-2(a)(19)] ("independent directors"), will consider the extent to which (if any) the advisory fees charged by the adviser should be reduced to account for reduced services as a result of investing cash in the money market fund; (iii) the acquiring fund's investment in money market funds will be limited to 25 percent of the acquiring fund's total assets; (iv) the acquiring fund's investment in the money market fund is consistent with the acquiring fund's policies as set forth in its registration statement; (v) the acquiring fund and money market fund are advised by the same adviser (or are part of the same group of investment companies); and (vi) the acquired money market fund will not acquire securities in another fund in excess of the limits of section 12(d)(1)(A) of the Act.

<sup>37</sup> See, e.g., Pioneer America Income Trust, First Amended and Restated Application pursuant to

Moreover, use of a money market fund may permit fund portfolio managers to focus on the management of the principal investments of the fund.

Fund investments in money market funds, which did not exist in 1940, do not appear to raise the concerns that underlie section 12(d)(1). Money market funds are designed to accommodate significant daily inflows and outflows of cash and therefore their management seems unlikely to be influenced by investors who could threaten large redemptions.<sup>38</sup> There is little value to obtaining a control position in a money market fund, and money market funds do not control valuable brokerage commissions that can be directed to affiliates.<sup>39</sup> A fund's investment in shares of a money market fund does, however, present the opportunity for layering of advisory fees and distribution expenses, which we propose to address as discussed in section II.D below.

#### 1. Scope of Exemption

(a) *Affiliated Money Market Funds.* Funds that intend to invest in money market funds in the same fund complex ("affiliated money market funds") also need exemptions from sections 17(a)<sup>40</sup>

Section 12(d)(1)(J) of the Investment Company Act of 1940, section IV (filed June 4, 2002) ("Pioneer Application"); Bear Stearns Funds, et al., Amended Application for an Order under Section 12(d)(1)(J) of the Investment Company Act of 1940, section III.C (filed Jan. 8, 1999).

<sup>38</sup> See Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 21837 (Mar. 21, 1996) [61 FR 13956, 13957 (Mar. 28, 1996)] (among money market fund objectives is preservation of capital and liquidity); Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 17589 at text preceding n.7 (July 17, 1990) [55 FR 30239 (July 25, 1990)] (many investors use money market accounts as alternatives to checking accounts).

<sup>39</sup> We note that in the context of rule 2a-7, the Commission has permitted an exception that allows money market funds to invest in other money market funds in excess of the diversification requirements for other issuers provided the board of directors of the acquiring fund reasonably believes that the acquired fund is in compliance with rule 2a-7. See 17 CFR 270.2a-7(c)(4)(ii)(E). Under rule 2a-7, shares of money market funds are considered first-tier securities that without the exception would be subject to the rule's issuer diversification standards for first-tier securities. See 17 CFR 270.2a-7(a)(12).

<sup>40</sup> Section 17(a)(1) prohibits an affiliated person of a registered fund, a promoter or principal underwriter for a registered fund, or an affiliated person of the foregoing, acting as principal, from selling securities or other property to the fund, unless (A) the buyer is the issuer of the securities, (B) the seller is the issuer of the securities and the securities are part of a general offering to the holders of a class of the seller's securities, or (C) a depositor has deposited the securities with the trust of a UIT or periodic payment plan. 15 U.S.C. 80a-17(a)(1). Section 17(a)(2) prohibits an affiliated person from knowingly buying from a registered fund (or companies it controls) any security or other property unless the seller is the issuer of the

and 17(d) of the Act, and rule 17d-1 thereunder,<sup>41</sup> which restrict transactions and joint arrangements with affiliated persons. In addition, a fund that acquires more than five percent of the securities of a money market fund in another fund complex would become an affiliated person of the money market fund, and would need relief from these section 17 prohibitions before making any additional investments in the money market fund.<sup>42</sup> Proposed rule 12d1-1 would provide this relief. An acquiring fund's purchase and redemption of

securities. 15 U.S.C. 80a-17(a)(2). Affiliated persons of a fund include any person directly or indirectly controlling, controlled by, or under common control with the fund. 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 a number of other funds in the same fund complex. Funds in a fund complex are under the common control of an investment adviser or other person when the adviser or other person exercises 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 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, n.14 (Nov. 8, 2001) [66 FR 57602 (Nov. 15, 2001)]. 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 proposed exemptions from section 17(a) and rule 17d-1.

<sup>41</sup> Section 17(d) of the Act makes it unlawful for an affiliated person of a registered fund ("first-tier affiliate"), an affiliated person of an affiliated person of a registered fund ("second-tier affiliate"), the fund's principal underwriters, or 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 such rules and regulations as the Commission may prescribe for the purpose of limiting or preventing participation by such registered or controlled company on a basis different from or less advantageous than that of such other participant." 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 underwriter, 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 company it controls) is a participant "unless an application regarding such joint enterprise, arrangement or profit-sharing plan has been filed with the Commission and has been granted by an order \* \* \*." 17 CFR 270.17d-1. When an acquiring fund purchases securities from an affiliated money market fund on the advice of an adviser who also manages the money market fund, the arrangement and transactions could be deemed to be a joint enterprise in which the two funds and the adviser are joint participants.

<sup>42</sup> An affiliated person of a fund 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 assets or 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) (definition of "affiliated person").

money market fund shares at the net asset value would seem to provide little opportunity for insider self-dealing or overreaching, and thus an exemption from these provisions appears to be appropriate. We seek comment on this proposal. Does an acquiring fund's investment in an affiliated money market fund create other opportunities for self-dealing or overreaching?

(b) *Unaffiliated Money Market Funds.* Although our exemptive orders have permitted funds to invest their cash only in money market funds advised by the same adviser, we are proposing to expand that relief to funds that do not share the same adviser.<sup>43</sup> As a result, funds would be able to invest cash in money market funds that are members of other fund complexes. The exemption would permit funds in smaller complexes that do not have a money market fund to engage in a cash sweep arrangement.<sup>44</sup> Because of the nature of money market funds, which we discussed above, we do not believe that investments in money market funds that do not share the same adviser would create any greater risks than investments in money market funds with a common adviser.

If a fund acquires more than five percent of a money market fund's securities, the two funds would become affiliated persons of each other.<sup>45</sup> As a result, principal transactions other than purchases and redemptions of fund shares would not be exempt under the proposed rule, and thus the two funds would be precluded from entering into certain types of transactions with each other.<sup>46</sup> Moreover, the acquiring fund would be restricted with respect to the purchase or sale of securities through a broker-dealer affiliated with the money market fund.<sup>47</sup> We seek comment on

<sup>43</sup> Some applicants have sought, and we have granted, broader exemptive relief permitting funds to invest in funds that are not part of the same group of investment companies in excess of the limitations of section 12(d)(1). See *infra* notes 73, 75. Under those orders, funds in which the applicants could invest include money market funds.

<sup>44</sup> See H.R. Rep. No. 622, *supra* note 18, at 43 ("The Committee intends the rulemaking and exemptive authority in new Section 12(d)(1)(f) to be used by the Commission so that the benefits of funds [of funds] are not limited only to investors in the largest fund complexes, but, in appropriate circumstances, are available to investors through a variety of different types and sizes of investment company complexes.")

<sup>45</sup> See 15 U.S.C. 80a-2(a)(3)(A), (B).

<sup>46</sup> See discussion above in section II.A.1(a). We note that rule 17a-7 provides an exemption for purchase and sale transactions between registered funds (or series of registered funds) that are affiliated and that meet certain conditions regarding the nature of the funds' affiliation. 17 CFR 270.17a-7.

<sup>47</sup> Section 17(e) of the Act prohibits a first or second-tier affiliate of a registered fund that acts as

whether funds would be likely to invest cash in money market funds in other fund complexes? If so, would additional exemptive relief under the proposed rule be appropriate?<sup>48</sup>

(c) *Unregistered Money Market Funds.* Proposed rule 12d1-1 also would codify our exemptive orders that permit funds to invest in money market funds that are not registered investment companies ("unregistered money market funds").<sup>49</sup>

broker, in connection with the sale of securities to or by the fund, from receiving from any source a commission, fee, or other remuneration for effecting the transaction that exceeds specified limits. See 15 U.S.C. 80a-17(e)(2).

<sup>48</sup> We have provided relief for transactions between a fund and another entity that are affiliated as a result of the fund's investments in a money market fund that is affiliated with the other entity. See, e.g., Credit Suisse Asset Management, LLC, Investment Company Act Release No. 25789 (Oct. 29, 2002) [67 FR 67220 (Nov. 4, 2002)] (notice), Investment Company Act Release No. 25832 (Nov. 22, 2002) (order) ("Credit Suisse Notice and Order"). This relief generally has been provided in connection with applications regarding securities lending programs. We are considering separate rulemaking in this area that would address those issues.

<sup>49</sup> See, e.g., Pioneer America Income Trust, Investment Company Act Release No. 25607 (June 7, 2002) [67 FR 40757 (June 13, 2002)] (notice), Investment Company Act Release No. 25647 (July 3, 2002) (order) ("Pioneer Notice and Order"); Bear Stearns Funds et al., Investment Company Act Release No. 25467 (Mar. 20, 2002) [67 FR 13809 (Mar. 26, 2002)] (notice), Investment Company Act Release No. 25527 (Apr. 16, 2002) (order); GE Funds, et al., Investment Company Act Release No. 22187 (Aug. 29, 1996) [61 FR 46876 (Sept. 5, 1996)] (notice), Investment Company Act Release No. 22247 (Sept. 25, 1996) (order). The exemptive relief provided in these orders includes conditions requiring that: (i) The unregistered money market fund comply with rule 2a-7; (ii) the investment adviser to the unregistered money market fund (or the fund with approval of its board of directors) adopt and monitor the procedures described in rule 2a-7 and take any other actions required to be taken under the procedures; (iii) an acquiring fund purchase shares of an unregistered money market fund only if the unregistered money market fund's adviser determines on an ongoing basis that the unregistered money market fund is in compliance with rule 2a-7 and preserves for a period not less than six years from the date of determination, the first two years in an easily accessible place, a record of the determination and the basis on which it was made, and the record is subject to examination by Commission staff; (iv) the unregistered money market fund comply with the requirements of sections 17(a), (d), and (e), 18, and 22(e) of the Act as if it were a registered open-end fund; (v) the investment adviser to the unregistered money market fund adopt procedures designed to ensure that the fund complies with those provisions of the Act, periodically reviews and updates as appropriate the procedures, and maintains books and records describing the procedures; (vi) the investment adviser to the unregistered money market fund maintains the records required by rules 31(a)-1(b)(1), 31a-1(b)(ii)(2), and 31a-1(b)(9) under the Act for a period of not less than six years from the end of the fiscal year in which any transaction occurred, the first two years in an easily accessible place and subject to examination by Commission staff; (vii) the net asset value per share with respect to unregistered money market fund shares is determined by dividing the value of the assets belonging to the fund, less the liabilities of the

Unregistered money market funds are typically organized by a fund adviser for the purposes 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 of 1933.<sup>50</sup> Although a fund's investments in unregistered money market funds is no longer restricted by section 12(d)(1),<sup>51</sup> these investments are subject to the affiliate transaction restrictions in the Act and rules thereunder and thus require exemptions from sections 17(a) and 17(d), and rule 17d-1.<sup>52</sup>

Under the proposed rule, the exemption would be available only for investments in an unregistered money market fund that operates like a money market fund registered under the Act.<sup>53</sup> To be eligible, an unregistered money market fund would be required to (i) limit its investments to those in which a money market fund may invest under

fund, by the number of outstanding shares of the fund; (viii) the acquiring fund purchase and redeem shares of the unregistered money market fund as of the same time and at the same price, and receive dividends and bear its proportionate share of expenses on the same basis, as other shareholders of the unregistered money market fund; and (ix) a separate account is established in the shareholder records of the unregistered money market fund for the account of the acquiring fund. These orders provide exemptions for funds with the same adviser as the unregistered money market funds. The proposed rule would permit funds to invest in unregistered money market funds with the same or a different adviser.

<sup>50</sup> See, e.g., Pioneer Application, *supra* note 37, conditions 7.<sup>8</sup> See also 15 U.S.C. 80a-3(c)(1) (excepting from the definition of "investment company" issuers 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" issuers 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>51</sup> Before 1996, a fund that was excepted from the definition of "investment company" by section 3(c)(1) of the Act (because its shares were held by fewer than 100 beneficial owners and was not making and did not propose to make a public offering of its securities) was nonetheless deemed to be an "investment company" for purposes of section 12(d)(1). In 1996, Congress narrowed this provision of section 3(c)(1) to make section 12(d)(1) limitations inapplicable to an investment by a registered fund in shares of a fund that is not registered with us in reliance on section 3(c)(1). See NSMIA, *supra* note 25 § 209(a). A parallel provision was incorporated into section 3(c)(7), which excepts from the definition of "investment company" funds whose outstanding securities are owned exclusively by "qualified purchasers" and that is not making and does not propose to make a public offering of its securities. See section 3(c)(7)(D) [15 U.S.C. 80a-3(c)(7)(D)]. See also 1992 Study, *supra* note 17, at 105-110.

<sup>52</sup> See discussion above in section II.A.1(a) of this Release.

<sup>53</sup> Proposed rule 12d1-1(c)(3)(ii).

rule 2a-7 under the Act,<sup>54</sup> and (ii) undertake to comply with all the other provisions of rule 2a-7.<sup>55</sup> In addition, the acquiring fund would have 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>56</sup> Finally, the unregistered money market fund's adviser would be required to register as an investment adviser with the Commission.<sup>57</sup> This final requirement would allow the Commission to examine the activities of the unregistered money market fund to ensure that it is meeting the requirements of the rule.

(d) *Closed-End Funds of Funds.* The restrictions of section 12(d)(1) on a fund of funds also apply to closed-end funds and business development companies,<sup>58</sup> which are closed-end funds that are exempted from registration under the Act.<sup>59</sup> We have issued several

<sup>54</sup> Proposed rule 12d1-1(c)(3)(ii)(A).

<sup>55</sup> Proposed rule 12d1-1(c)(3)(ii)(B).

<sup>56</sup> Proposed rule 12d1-1(b)(2)(i)(A), (B). The acquiring fund would be required to reasonably believe that the unregistered money market fund (i) operates in compliance with rule 2a-7, (ii) complies, as if it 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)), (iii) has adopted, and periodically reviews, procedures designed to ensure compliance with these requirements, and maintains books and records describing the procedures, and (iv) maintains and preserves the books and records required under rules 31a-1(b)(1) [17 CFR 31a-1(b)(1)], 31a-1(b)(2)(ii) [17 CFR 31a-1(b)(2)(ii)], 31a-1(b)(2)(iv) [17 CFR 31a-1(b)(2)(iv)], and 31a-1(b)(9) [17 CFR 31a-1(b)(9)]. Proposed rule 12d1-1(b)(2)(i). The proposed rule would require that the acquiring fund "reasonably believe" that, among other things, the acquired money market fund complies with rule 2a-7 in order to avoid the acquiring fund's loss of the exemption as the result of a minor or inadvertent violation of rule 2a-7 by the acquired money market fund.

<sup>57</sup> Proposed rule 12d1-1(b)(2)(ii). If an unregistered money market fund does not have a board of directors (because, for example, it is organized as a limited partnership), the proposed rule also would require the fund's investment adviser to perform the duties required of a money market fund's board of directors under rule 2a-7. Proposed rule 12d1-1(c)(3)(ii)(B).

<sup>58</sup> A business development company is any closed-end company that: (i) Is organized under the laws of, and has its principal place 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>59</sup> Section 6(f) of the Act [15 U.S.C. 80a-6(f)] exempts business development companies that have made the election under section 54 [15 U.S.C. 80a-53] from registration and other provisions of the Act.

exemptive orders to closed-end funds, subject to similar conditions as open-end funds.<sup>60</sup> Today, we propose to make the new rule available to both types of funds so that either can invest available cash in a money market fund.<sup>61</sup> Would business development companies benefit from this exemption? Are there reasons not to extend the exemption to business development companies?

(e) *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>62</sup> The proposed rule would permit unregistered funds to invest their cash in shares of a registered money market fund.<sup>63</sup> Thus, a hedge fund could sweep its cash into a registered money market fund pending investment or distribution of the cash to investors. We request comment on whether any special concerns arise with respect to unregistered funds' use of registered money market funds in cash sweep arrangements.

## 2. Conditions

We propose to eliminate most of the conditions included in the exemptive orders provided to cash sweep arrangements.<sup>64</sup> We would not, for example, preclude a fund from investing more than 25 percent of its assets in shares of money market funds and would, instead, rely on a fund's own investment restrictions to provide appropriate limitations. We also would not require directors to make any special findings that investors are not paying multiple advisory fees for the same services. 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

<sup>60</sup> See, e.g., Pioneer Notice and Order, *supra* note 49; Credit Suisse Notice and Order, *supra* note 48.

<sup>61</sup> The amount of assets a business development company could invest in a money market fund may be limited by Section 55 of the Act [15 U.S.C. 80a-54].

<sup>62</sup> See 15 U.S.C. 12(d)(1)(A); 15 U.S.C. 12(d)(1)(B). In the case of unregistered investment companies (such as a foreign fund or business development company) 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 under sections 3(c)(1) and 3(c)(7) of the Act are prohibited from acquiring more than three percent 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. As a result, these companies cannot acquire more than three percent of the shares of a registered fund. See 15 U.S.C. 80a-3(c)(1); 15 U.S.C. 80a-3(c)(7)(D).

<sup>63</sup> Proposed rule 12d1-1(a).

<sup>64</sup> See *supra* note 36.

the cash.<sup>65</sup> Fund directors have fiduciary duties,<sup>66</sup> which obligate them to protect funds from being overcharged for services provided to the fund, regardless of any special findings we might require.<sup>67</sup> Moreover, and as we describe in more detail below, we would 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>68</sup>

<sup>65</sup> Our earlier orders required the acquiring fund's adviser to waive that portion of the advisory fee attributable to the management service that would be performed by the adviser to the acquired fund. See, e.g., The Brinson Funds, Investment Company Act Release No. 21814 (Feb. 12, 1996) [61 FR 6398, 6399 (Feb. 20, 1996)] (notice), Investment Company Act Release No. 21741 (Mar. 11, 1996) (order); Janus Investment Fund, Investment Company Act Release No. 21042 (May 4, 1995) [60 F.R. 24955, (May 10, 1995)] (notice), Investment Company Act Release No. 21103 (May 31, 1995) (order).

<sup>66</sup> See 15 U.S.C. 80a-35(a). See generally, 2 Tamar 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). Moreover, we believe that, section 36(b) [15 U.S.C. 80a-35(b)], which imposes on fund advisers a fiduciary duty with respect to their compensation, would require an adviser to waive that portion of its fee that represents compensation for services being performed by another person, such as the adviser to an acquired money market fund. See *SEC v. American Birthright Trust Management Company, Inc.*, Litigation Release No. 9266 (Dec. 30, 1980), available in LEXIS, Fedsec Library, Litrel File (settlement of civil injunctive action in which defendant investment adviser was permanently enjoined from engaging in acts and practices that would constitute violations of sections 36(a) and (b) of the Act, and in which the Commission alleged that the compensation paid to fund's adviser was excessive in light of the services performed, and that most of the advisory services had been provided by a "sub-adviser" retained by the adviser).

<sup>67</sup> We also would eliminate the prohibition on an acquired money market fund investing in other funds in excess of the limits in section 12(d)(1)(A). This would permit the money market fund itself to have a cash sweep arrangement. As discussed above, we do not believe that investments in money market funds create the concerns that led to the limitations in section 12(d)(1). See *supra* notes 38-39 and accompanying text. We also would omit a condition that the acquiring fund's investment in the acquired money market fund must be consistent with the policies set forth in the acquiring fund's registration statement. We believe that the fund already is required to make investments consistent with those policies without an additional requirement in the rule. For a discussion of the other conditions, see *supra* notes 43-44 and accompanying text.

<sup>68</sup> Although not contained in the text of proposed rule 12d1-1, the proposed disclosure requirements are a critical element of the relief we are proposing today and of our decision that the proposal omit required directors' findings from the rule. We note that when it enacted section 12(d)(1)(G) in 1996, Congress did not include any provision addressing the duplication of advisory fees, although it understood that our previous exemptive orders to permit these arrangements included a requirement

We would, however, retain one of the conditions of our orders relating to fees. Under proposed rule 12d1-1, the acquiring fund either would not pay any sales load, distribution fees, or service fees on acquiring fund shares, or if it did, the acquiring fund's investment adviser would have to waive a sufficient amount of its advisory fee to offset the cost of the loads or distribution fees.<sup>69</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 distribution fees to the acquiring fund may not be an appropriate investment for that fund.

Comment is requested on the proposed rule. Should we retain any of the other conditions of the exemptive orders? Should a fund be limited in the amount of assets it can invest in one or more money market funds? If so, what is the appropriate limit? Should the proposed rule require fund directors to make findings regarding duplicative fees? Do the sponsors, advisers, or directors of money market funds have any concerns about other funds making large investments in their money market funds? Should we include any restrictions on the ability of an acquiring fund to redeem shares of a money market fund that is not part of the same group of investment companies?<sup>70</sup> Should we restrict the ability of an acquiring fund to vote shares of a money market fund that is

that acquiring fund directors determine that fees for advisory services provided to the acquiring fund are in addition to and not duplicative of fees paid for advisory services provided to the acquired funds. In his testimony before the House Subcommittee considering amendments to section 12(d)(1), the Director of our Division of Investment Management explained that such a condition was unnecessary because "[t]he Commission would be able to use its authority under the Securities Act [of 1933] to \* \* \* address the potential for excessive layering of advisory fees by requiring an acquiring fund to disclose in the prospectus fee table the cumulative advisory fees paid by the acquiring and acquired funds." *Hearing on H.R. 1495 Before the Subcomm. on Telecommunications and Finance of the House Comm. on Commerce*, 104th Cong., 1st Sess. 19 (1995) (statement of Barry P. Barbash, Director, Division of Investment Management, Securities & Exchange Commission). See also *Hearing on S. 1815 Before the Senate Comm. on Banking, Housing and Urban Affairs*, 104th Cong., 2d Sess. 38 (1996) (statement of Arthur Levitt, Jr. Chairman, Securities and Exchange Commission).

<sup>69</sup> Proposed rule 12d1-1(b)(1). The proposed rule refers to "administrative fees," which it would define as "any sales charge, as defined in rule 2830(b)(8) of the Conduct Rules of the NASD 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."

<sup>70</sup> A fund relying on section 12(d)(1)(F) may not redeem more than 1 percent of an acquired fund's shares during any period of less than 30 days. 15 U.S.C. 80a-12(d)(1)(F).

not part of the same group of investment companies?<sup>71</sup> Are there reasons to restrict the ability of an acquired money market fund itself to have a cash sweep arrangement?

Some funds considering a cash sweep arrangement may not have an investment policy that specifically addresses such an arrangement. Should we require funds to adopt a policy before investing in shares of a money market fund? Alternatively, should we interpret fund investment policies and restrictions that apply to investments in money market instruments as applying to investments in money market funds?

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

As discussed above, section 12(d)(1)(G) permits a registered 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. Since 1996, when the section was added to the Act, we have issued exemptive orders for a variety of 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.<sup>72</sup>

Proposed rule 12d1-2 would codify, and in some cases expand, three types of relief provided to affiliated funds of funds.<sup>73</sup> In each case, the proposed rule provides relief from section 12(d)(1)(G) limitations on investments an affiliated fund of funds can make in addition to shares of funds in the same group of

<sup>71</sup> A fund relying on section 12(d)(1)(F) must vote shares of an acquired fund either by seeking instructions from its shareholders, or in the same proportion as the vote of all other shareholders of the acquired fund. 15 U.S.C. 80a-12(d)(1)(F) (referencing 15 U.S.C. 80a-12(d)(1)(E)).

<sup>72</sup> See, e.g., Scudder Kemper Investments, Inc., Investment Company Act Release No. 23691 (Feb. 11, 1999) [64 FR 8153 (Feb. 18, 1999)] (notice), Investment Company Act Release No. 23731 (Mar. 8, 1999) (order) (permitting a fund to invest in funds in the same group of investment companies and in limited amounts of funds in different fund companies); Nations Fund Trust, Investment Company Act Release No. 24781 (Dec. 1, 2000) [65 FR 77050 (Dec. 8, 2000)] (notice), Investment Company Act Release No. 24804 (Dec. 27, 2000) (order) (permitting a fund to invest in funds in the same group of investment companies and in other securities (not issued by another fund)).

<sup>73</sup> We are not at this time proposing to codify the broader relief we have granted to permit an affiliated fund of funds to acquire shares of funds in different groups of investment companies in excess of the limits of section 12(d)(1)(F). See Nationwide Life Insurance Co., Investment Company Act Release No. 25492 (Mar. 21, 2002) [67 FR 14735 (Mar. 27, 2002)] (notice), Investment Company Act Release No. 25528 (Apr. 16, 2002) (order); Schwab Capital Trust, Investment Company Act Release No. 24067 (Oct. 1, 1999) [64 FR 54939 (Oct. 8, 1999)] (notice), Investment Company Act Release No. 24113 (Oct. 27, 1999) (order).

investment companies. The other limitations in section 12(d)(1)(G) would continue to apply to a fund of funds relying on that provision.<sup>74</sup>

#### 1. Investments in Unaffiliated Funds

Section 12(d)(1)(G) permits a fund to acquire only funds that are part of the same group of investment companies. We propose to permit an affiliated fund of funds also 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).<sup>75</sup> This exemption would, in effect, permit funds to combine the relief provided by the statutory exceptions.<sup>76</sup> 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 mutual funds specifically permitted to purchase the shares by section 12(d)(1)(A) or 12(d)(1)(F). We seek comment on the proposed exemption. Are there greater risks to an acquired fund if the investor in these circumstances is an affiliated fund of funds?

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

To restrict the use of the exemption provided by section 12(d)(1)(G) to a "bona fide" fund of funds, Congress

<sup>74</sup> See *supra* notes 28-29, and accompanying text.

<sup>75</sup> Proposed 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 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 securities 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 would be prevented from redeeming more than 1 percent of the shares of any acquired fund during any period of less than 30 days. *Id.*

<sup>76</sup> We have issued a number of exemptive orders granting similar relief. See, e.g., Sage Life Assurance of America, Inc., Investment Company Act Release No. 25098 (Aug. 1, 2001) [66 FR 41272 (Aug. 7, 2001)] (notice), Investment Company Act Release No. 25142 (Aug. 28, 2001) (order); Scudder Kemper Investments, Inc., Investment Company Act Release No. 23691 (Feb. 11, 1999) [64 FR 8153 (Feb. 18, 1999)] (notice), Investment Company Act Release No. 23731 (Mar. 8, 1999) (order).

required a fund relying on the exemption to invest all of its assets in shares of funds in the same group of investment companies, and permitted other investments to include only government securities and short-term paper, which would provide the fund with a source of liquidity to redeem shares.<sup>77</sup> Congress encouraged us, however, to provide exemptions from these limitations "in a progressive way," taking into account factors that related to the protection of investors.<sup>78</sup>

We propose to permit an affiliated fund of funds to invest in any other securities (*i.e.*, securities not issued by a fund).<sup>79</sup> This exemption would permit an affiliated fund of funds to invest directly in stocks, bonds, and other types of securities if such investments are consistent with the fund's investment policies. These investments would allow an acquiring fund greater flexibility to meet investment objectives that may not be met as well by investments in other funds in the same fund group, while the investments would not seem to present any additional concerns that section 12(d)(1)(G) was intended to address.<sup>80</sup>

A potentially significant consequence of the proposed rule would be that an equity fund or bond fund could invest any portion of its assets in an affiliated fund if such an acquisition is consistent with the investment policies of the fund and the restrictions of the rule. Our exemptive orders have permitted arrangements under which fund complexes have, for example, established a fund investing in foreign securities and made that fund available exclusively to other funds in the fund complex. The other funds used an investment in the international fund to obtain exposure to foreign securities consistent with their investment objectives.<sup>81</sup> Investments in an affiliated fund by a fund investing in other types of securities would not seem to raise any greater concerns than would an investment by a fund investing entirely

in shares of affiliated funds. We note that section 12(d)(1)(G) already addresses concerns regarding excessive distribution-related fees in its fee limitations.<sup>82</sup> In addition, as noted above, we would address the concerns regarding excessive advisory fees through the proposed amendments to Forms N-1A and N-2 requiring disclosure of acquired fund expenses.<sup>83</sup> We seek comment on this proposal. Would any concerns arise if an affiliated fund of funds could invest directly in stocks, bonds, or other types of securities?

### 3. Investments in Money Market Funds

Proposed rule 12d1-2 would permit an affiliated fund of funds to invest in affiliated or unaffiliated money market funds in reliance on proposed rule 12d1-1, which, as discussed above, is designed to permit cash sweep arrangements involving money market funds.<sup>84</sup> An affiliated fund of funds currently is permitted to invest in money market funds in the same fund complex. The proposed rule would permit an affiliated fund of funds to invest in money market funds in a different fund complex. This will allow affiliated funds 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. We are conditioning the investment on compliance with proposed 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.

We request comment on proposed rule 12d1-2. Are there reasons not to permit an affiliated fund of funds to invest its assets in any securities other than affiliated funds, government securities, or short-term paper? If so, are there conditions we should include in

<sup>82</sup> See 15 U.S.C. 80a-12(d)(1)(G)(i)(III). See also *supra* note 29.

<sup>83</sup> As noted above, we would expect directors to address the issue of duplicative fees in the exercise of their fiduciary duties. See *supra* notes 66-68, and accompanying text.

<sup>84</sup> Proposed rule 12d1-2(a)(3). See *supra* notes 35-57, 64-71 and accompanying text. A collateral effect of our rule proposals would be to permit an affiliated fund of funds to invest in an acquired fund that itself had 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 proposed 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.

the proposed rule to protect against the risks that underlie the section 12(d)(1)(G)(i)(III) limitations?

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

Section 12(d)(1)(F) of the Act provides an exemption from section 12(d)(1)(A) 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 any acquired fund; and (ii) the sales load charged on the acquiring fund's shares is no greater than 1½ percent.<sup>85</sup>

Proposed rule 12d1-3 would permit 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 NASD for funds of funds.<sup>86</sup> The rule would codify a number of our exemptive orders.<sup>87</sup> Moreover, the limitations on distribution expenses reflect Congress's intent under NSMIA that the NASD regulate duplicative and excessive sales charges, as provided in section 12(d)(1)(G).<sup>88</sup> Our proposal would

<sup>85</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 acquired fund's shareholders or by voting in the same proportion as the other shareholders of the acquired fund. 15 U.S.C. 80a-12(d)(1)(F).

<sup>86</sup> See NASD Sales Charge Rule 2830(d)(3), *supra* note 29.

<sup>87</sup> The conditions in these orders limit aggregate sales charges to the limits imposed under the NASD Sales Charge Rule. See, e.g., Investec Ernst Company, Investment Company Act Release No. 25507 (Apr. 3, 2002) [67 FR 16775 (Apr. 8, 2002)] (notice), Investment Company Act Release No. 25552 (Apr. 24, 2002) (order); Lifetime Achievement Fund, Inc., Investment Company Act Release No. 24453 (May 12, 2000) [65 FR 31948 (May 19, 2000)] (notice), Investment Company Act Release No. 24489 (June 7, 2000) (order).

<sup>88</sup> See 15 U.S.C. 80a-12(d)(1)(G)(i)(III)(bb) (a fund relying on section 12(d)(1)(G) is limited from imposing sales loads and other distribution-related fees that, when aggregated with sales loads and distribution fees paid on acquired fund shares, are excessive under rules adopted under section 22(b) or 22(c) of the Act by a securities association registered under section 15A of the Securities Exchange Act or the Commission). In 1970, sales loads commonly were 8½ percent of the total payment, see Sen. Rep. No. 184, *supra* note 11, at 7, which would have resulted in an aggregate load of 10 percent of the total payment under the sales load limitation in section 12(d)(1)(F). The NASD Sales Charge Rule limits the aggregate sales loads on a fund of funds to 8½ percent if neither the acquiring fund nor the acquired fund in a fund of funds charges an asset-based sales charge, and to less than 8½ percent if they do. In addition, the

Continued

<sup>77</sup> See H.R. Rep. No. 622, *supra* note 18, at 42.

<sup>78</sup> *Id.* at 43-44.

<sup>79</sup> Proposed rule 12d1-2(a)(2).

<sup>80</sup> Unlike section 12(d)(1)(G), section 12(d)(1)(F) does not restrict the other types of securities in which an unaffiliated fund of funds may invest.

<sup>81</sup> See Van Kampen American Capital Comstock Fund, Inc., Investment Company Act Release No. 21977 (May 23, 1996) [61 FR 27118 (May 30, 1996)] (notice), Investment Company Act Release No. 22025 (June 18, 1996) (order). See also Smith Breeden Trust, Investment Company Act Release No. 23918 (July 21, 1999) [64 FR 40923 (July 28, 1999)] (notice), Investment Company Act Release No. 23947 (Aug. 17, 1999) (order) (permitting funds to acquire shares of another fund in the same group of investment companies that invests primarily in mortgage-backed securities issued by the U.S. government, its agencies, and instrumentalities).

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). We seek comment on the proposed rule. Are there reasons to retain the 1½ percent sales load limit under an unaffiliated fund of funds arrangement rather than limit sales loads and distribution fees in conformance with section 12(d)(1)(G)(i)(III) limits for affiliated funds of funds?

*D. Amendments to Forms N-1A, N-2, N-3, N-4, and N-6*

We also are proposing amendments to Forms N-1A, N-2, N-3, N-4, and N-6 that would require that investors in a registered fund of funds receive better disclosure of the costs of investing in these arrangements. The proposed disclosure is designed to help investors understand the full costs of investing in a fund of funds, both to assist them in comparing the costs of investing in alternative funds of funds and in comparing the cost of an investment in a fund of funds with the cost of a more traditional fund.<sup>89</sup>

Our current disclosure rules do not require funds (other than feeder funds) to provide information about the cost associated with investments in acquired funds.<sup>90</sup> Some funds of funds disclose expenses of acquired funds as an item of the acquired fund's annual operating expenses.<sup>91</sup> Other funds list the

NASD Sales Charge Rule limits aggregate asset-based sales charges the funds may impose. See *supra* note 29.

<sup>89</sup> A fund of funds may have higher fees and expenses than a fund that invests directly in debt and equity securities. See John Shipman, *Diversifying Through Funds of Funds—Small Investors Get Exposure to a Variety of Categories, But Fees, Overlap Are Issues*, Wall St. J., Nov. 7, 2002, at D11 (“[a]t least half of the funds of funds available to investors charge fees—amounting to more than 2% of assets in some cases—on the underlying portfolio, in addition to the costs of the underlying portfolios.”); Yuka Hayashi, *Schwab Abandons “Fund of Funds”—High Fees Were Obstacle to Drawing Investors; New Managers to Step In*, Wall St. J., June 17, 2002, at C17 (“[t]he biggest problem was the high fees that Schwab had to charge in order to cover its own asset-management costs, as well as those of underlying funds.\* \* \*”).

<sup>90</sup> A feeder fund must disclose in its fee table the aggregate expenses of the feeder fund and master fund. See Instruction 1(d)(i) to Item 3, Form N-1A. For a description of feeder funds, see text accompanying note 18, *supra*.

<sup>91</sup> See, e.g., GE Lifestyle Funds, Prospectus 10 (January 27, 2003), available at <http://www.sec.gov/Archives/edgar/data/1018218/000091205702002852/0000912057-02-002852-index.htm>.

operating expense ratios of each acquired fund, without relating those costs to the acquiring fund's expenses.<sup>92</sup> Still other funds merely note that the shareholder will indirectly bear a proportionate share of fees and expenses charged by acquired funds. In some cases, funds of funds provide no information regarding acquired funds' expenses. As a result, investors cannot always appreciate the total costs of investing in a fund of funds. Currently they have no direct means to determine whether the indirect costs of acquired funds will result in a higher overall cost of investing in a fund of funds when compared with another fund of funds, or a more traditional fund.

Under the proposed amendments to Form N-1A, any registered open-end fund investing in shares of another fund would be required to include in the fee table in its prospectus an additional line item under the section that discloses annual operating expenses.<sup>93</sup> The line item would set forth the acquiring fund's pro rata portion of the cumulative expenses charged by funds in which the acquiring fund invests. Those costs would be included in the acquiring funds' total annual operating expenses, which would be reflected in the “Example” portion of the fee table.<sup>94</sup> We seek comment on the proposed disclosure. Will the additional disclosure provide helpful information to investors? Is there a more informative means of providing investors information about the costs of acquired funds? Should the subcaption be included in Form N-1A with an instruction that it may be omitted for funds that do not invest in other funds?

We also are proposing instructions to the fee table to assist an acquiring fund in determining the amount of fees and expenses associated with acquired funds that must be reflected in the acquiring fund's fee table. The instructions would reflect expenses associated with the historical holdings in each acquired fund. The calculation would require the acquiring fund to aggregate the operating expenses of acquired funds and transaction costs and express them as a percentage of average net assets of the acquiring

<sup>92</sup> Some of these funds note that expenses will differ depending on the acquiring fund's asset allocation in the acquired funds.

<sup>93</sup> The item would appear directly above the line item titled “Total Annual Fund Operating Expenses.”

<sup>94</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% return. See Item 3, Form N-1A.

fund.<sup>95</sup> Under this approach, the acquiring fund would calculate the average invested balance and number of actual days invested in each acquired fund.<sup>96</sup> We ask for comment on these instructions. Are they consistent with the current fee table? Is there another way to determine acquired funds' fees and expenses that would provide better disclosure of these costs? <sup>97</sup> The instructions require the calculation of an average invested balance, which is based on a monthly average.<sup>98</sup> Should the average be calculated on a more frequent basis?

Expenses of the acquiring fund would be based on actual expenses or those reported in the most recent communication from the acquired fund.<sup>99</sup> Expenses of an acquired fund that is part of the same group of investment companies should reflect actual expenses of the fund. Expenses of other funds may be based on annual expenses reported in the most recent report or other communication received by the fund of funds.<sup>100</sup> If the acquiring fund paid any sales load to acquire shares of a fund during the past fiscal year, it must include that amount in its

<sup>95</sup> This approach is consistent with the current requirement that a feeder fund disclose the aggregate expenses of the feeder fund and master fund. See *supra* note 90.

<sup>96</sup> See proposed instruction 3(f)(ii) to Item 3, Form N-1A (to calculate the pro rata share of total operating expenses for each acquired fund, an acquiring fund would divide the acquired fund's total operating expense ratio by 365 days, and multiply the result by the average daily balance invested in the acquired fund and the number of days invested in the acquired fund).

<sup>97</sup> For example, the instructions could require an acquiring fund to take the amounts invested in each acquired fund as of a current measurement date and multiply those amounts by the corresponding total annual fund operating expense ratio for the acquired fund. This would require a fairly simple calculation based on investments on a single day that would reflect the acquired fund's asset size on the measurement date, rather than the actual results that are indirectly included in the acquiring fund's operations. Because it would be based on the most recent allocation of fund assets, this method may also disclose the expenses an investor is more likely to pay. The proposed instructions, however, are less likely to result in an understatement or overstatement of actual expenses paid by the acquiring fund.

<sup>98</sup> See proposed instruction 3(f) to Item 3, Form N-1A.

<sup>99</sup> The operating expenses for acquired funds are likely to be for a different period than that of the acquiring fund's fiscal year. If the acquiring and acquired funds are not part of the same fund complex, the acquiring fund would rely on operating expenses the acquired fund has disclosed in its most recent semi-annual report. Those expenses would be for a period that ended before publication of the report, and thus was before the acquiring fund's most recent fiscal year. If the acquiring and acquired funds are part of the same fund complex, the two funds may still have different fiscal years.

<sup>100</sup> See proposed instruction 3(f)(iv) to Item 3, Form N-1A.

fee table (even if it no longer holds shares of that fund).<sup>101</sup>

The proposed disclosure requirements also would 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>102</sup> We do not see any reason to treat fund investments in these unregistered funds differently from investments in registered funds. Thus, a fund with a cash sweep arrangement could not avoid reporting the unregistered money market fund's expenses merely because the fund was not registered under the Act. Is there a basis for treating disclosure of unregistered and registered fund expenses differently?

Because we also are proposing to amend Form N-2, a registered closed-end fund of hedge funds would be required to include a pro rata portion of the hedge funds' expenses in its fee table.<sup>103</sup> In the case of a newly offered fund, including a newly offered fund of hedge funds, the fee table would reflect expenses the fund expects to incur based on its initial investments.<sup>104</sup> This approach is similar to that required of new funds.<sup>105</sup> We seek comment on the proposed amendments to Form N-2. In addition to the proposed instructions,

<sup>101</sup> See proposed instruction 3(f)(ii) to Item 3 ("transaction fees" included in the calculation for 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 shares in acquired funds during the year).

<sup>102</sup> See proposed instruction 3(f)(1) to Item 3. See also 15 U.S.C. 80a-3(c)(1), 80a-3(c)(7), and *supra* note 50. High fees also are a concern with funds of hedge funds. 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)) ("Expenses in funds of hedge funds are significantly higher than most mutual funds."); Stephen J. Brown, William N. Goetzmann, and Bing Lang, Fees on Fees in Funds of Funds 18 (National Bureau of Econ. Research Working Paper No. 9464, 2003) ("The chief disadvantage of [funds of hedge funds] is the high fees that are typically charged \* \* \*"). See also Daniel Kadlac, *Affordable Hedge Funds*, Time.com, <http://www.time.com/globalbusiness/html> ("The big drawback [of a fund of hedge funds] is that you pay two layers of fees: one to the fund-of-funds manager, who in turn gets charged by each fund in the portfolio.").

<sup>103</sup> See proposed instruction 10 to Item 3, Form N-2.

<sup>104</sup> See proposed instruction 3(f)(vi) to Item 3, Form N-1A. See also instruction 6 to Item 3, Form N-2.

<sup>105</sup> See Instruction 5(a) to Item 3, Form N-1A (new funds are instructed to base percentages to be included in the "Annual Fund Operating Expense" portion of the fee table on amounts that will be incurred (without reduction for expense reimbursement or fee waiver arrangements), estimating amounts of "Other Expenses").

are there additional matters our instructions should cover?

Our proposal also would require separate accounts to include in their registration forms, disclosures regarding the expenses of acquired funds. The proposal includes amendments to Forms N-3, N-4, and N-6.<sup>106</sup> We seek comment on the amendments to these forms. Are the different instructions appropriate to the respective forms?<sup>107</sup>

### III. General Request for Comments

We request comment on the proposed rules and form amendments that are the subject of this release, suggestions for additional provisions or changes to the rules and form amendments, and comments on other matters that might have an effect on the proposals contained in this release. We encourage commenters to provide data to support their views.

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,<sup>108</sup> we also request information regarding the potential effect of the proposals on the U.S. economy on an annual basis. Commenters are requested to provide empirical data to support their views. The Commission strives to draft its rules according to principles outlined in its Plain English Handbook.<sup>109</sup> We invite your comments on how to make the proposed rules and form amendments more consistent with those principles and easier to understand.

### IV. Cost-Benefit Analysis

We are sensitive to the costs and benefits imposed by our rules. The proposed rules would provide relief to investment companies by providing additional exemptions from the limitations on fund of fund arrangements without requiring the funds to obtain an exemptive order. The proposed amendments to Forms N-1A, N-2, N-3, N-4, and N-6 would provide

<sup>106</sup> The proposed instructions to Form N-3 would require the same disclosure and calculation as required in the proposed instructions to Forms N-1A and N-2. The proposed instructions for Forms N-4 and N-6 are different, however, because those forms already require registrants to disclose expenses of funds ("portfolio companies") in which the separate account invests. See Item 3, Form N-4, Item 3, Form N-6. Accordingly, the proposed instructions to Forms N-4 and N-6 require that if a portfolio company invests in other funds, the registrant must include in the item disclosing the portfolio company's "other expenses," the Acquired Fund's fees and expenses calculated according to the proposed instructions to Form N-1A.

<sup>107</sup> See *supra* note 106.

<sup>108</sup> Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

<sup>109</sup> Office of Investor Education and Assistance, U.S. Securities and Exchange Commission, A Plain English Handbook (1998) (available on the Commission's Web site at <<http://www.sec.gov>>).

additional information to shareholders regarding the costs of acquired funds in a fund of funds arrangement. We have identified costs and benefits that may result from the proposed rules and form amendments, as described below.

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

Under current law, a fund is limited in the amount of securities it can acquire from another fund. In general under the Act, a registered fund (and companies it controls) cannot:

- Acquire more than three percent of another fund's securities;
- Invest more than five percent of its own assets in another fund; or
- Invest more than ten percent of its own assets in other funds in the aggregate.<sup>110</sup>

In addition, a registered open-end fund, its principal underwriter, and any registered broker or dealer cannot sell the fund's shares to another fund if, as a result:

- The acquiring fund (and any companies it controls) owns more than three percent of the acquired fund's stock; or
- All acquiring funds (and companies they control) in the aggregate own more than ten percent of the acquired fund's stock.<sup>111</sup>

The Act provides three exceptions from these limitations that permit certain fund of funds arrangements. First, section 12(d)(1)(E) permits a fund to invest all its assets in *one* other fund, provided that (i) the depositor or principal underwriter for the fund is a registered broker or dealer (or a person it controls), and (ii) the acquiring fund is subject to certain voting restrictions on the shares of acquired funds.<sup>112</sup> Second, under section 12(d)(1)(F), a registered fund may invest any amount of its assets in other funds, provided that the acquiring fund (together with its affiliates) acquires no more than three percent of the securities of any other fund.<sup>113</sup> These unaffiliated funds of funds are limited to charging a 1½ percent sales load on their shares and are subject to voting restrictions

<sup>110</sup> See 15 U.S.C. 80a-12(d)(1)(A). If an acquiring fund is not registered, these limitations apply only with respect to the acquiring fund's acquisition of registered funds.

<sup>111</sup> See 15 U.S.C. 80a-12(d)(1)(B).

<sup>112</sup> See 15 U.S.C. 80a-12(d)(1)(E). The acquiring fund must either seek instruction from its shareholders with regard to voting all proxies with respect to the acquired fund's securities or vote the acquired fund shares in the same proportion as the vote of all other shareholders. In addition, in the event the acquiring fund is not registered, it cannot substitute the acquired fund shares without Commission approval.

<sup>113</sup> See 15 U.S.C. 80a-12(d)(1)(F)(i).

regarding shares of acquired funds.<sup>114</sup> Finally, section 12(d)(1)(G) allows a registered open-end fund or UIT to invest any amount of its own assets in one or more other registered funds or UITs in the same group of investment companies.<sup>115</sup> These affiliated funds of funds are limited to investing in government securities and short-term paper in addition to funds in the same fund group.<sup>116</sup> The exemption also limits sales loads and distribution charges on fund shares, and requires that the acquired fund have a policy that it cannot acquire other fund shares in reliance on section 12(d)(1)(F) or 12(d)(1)(G) of the Act.<sup>117</sup>

We also have issued a number of exemptive orders that have broadened the ability of funds to invest in other funds. Over the past decade, we have issued over 80 orders that permit registered funds to invest in a money market fund advised by the same adviser.<sup>118</sup> Many of those orders also have permitted funds to invest in an unregistered fund operated as a money market fund.<sup>119</sup> In addition to these

<sup>114</sup> See 15 U.S.C. 80a-12(d)(1)(F). The acquiring fund is subject to the voting restrictions imposed under section 12(d)(1)(E). See *supra* note 112. In addition, no issuer of securities held by the acquiring fund is obligated to redeem more than 1 percent of its securities during any period of less than 30 days.

<sup>115</sup> See 15 U.S.C. 80a-12(d)(1)(G).

<sup>116</sup> See 15 U.S.C. 80a-12(d)(1)(G)(III).

<sup>117</sup> See 15 U.S.C. 80a-12(d)(1)(G)(III), (IV). Section 12(d)(1)(G)(III) provides that either (i) the acquiring company does not pay any distribution-related charges with respect to the acquired shares or the acquiring fund does not charge sales loads or distribution-related fees itself, or (ii) sales loads and distribution-related charges with respect to acquiring fund shares and acquired fund shares, when aggregated, are not excessive under rules adopted under section 22(b) or 22(c) of the Act by a securities association registered under section 15A of the Securities Exchange Act or the Commission.

<sup>118</sup> See *supra* note 36. These orders have included the following conditions: (i) Shares of the acquired money market fund are not subject to sales loads, distribution-related fees, or service fees, or if they are, the acquiring fund's adviser will waive its advisory fee in an amount to offset the amount of fees incurred by the acquiring fund; (ii) before approving any advisory contract for the acquiring fund, its board of directors, including a majority of independent directors, considers the extent to which (if any) the advisory fees charged by the adviser should be reduced to account for reduced services as a result of investing cash in the money market fund; (iii) the acquiring fund's investment in money market funds is limited to 25 percent of the acquiring fund's total assets; (iv) the acquiring fund's investment in the money market fund is consistent with the acquiring fund's policies as set forth in its registration statement; (v) the acquiring fund and money market fund are advised by the same adviser; and (vi) the acquired money market fund cannot acquire securities in another fund in excess of the limits of section 12(d)(1)(A) of the Act.

<sup>119</sup> Investments in unregistered funds have been subject to the following conditions: (i) The unregistered money market fund complies with rule 2a-7; (ii) the investment adviser to the unregistered

orders, we have permitted an affiliated fund of funds relying on section 12(d)(1)(G) to invest in funds outside the same fund group subject to the limitations of section 12(d)(1)(F), as well as in other securities not issued by a fund.<sup>120</sup>

The orders discussed above provide exemptions from statutory limitations. A fund that obtains the benefit of the exemption incurs costs of applying for an exemptive order as well as costs of satisfying any conditions imposed in the order. The 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. By contrast, 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.

money market fund (or the fund with approval of its board of directors) adopts and monitors the procedures described in rule 2a-7 and takes the other actions required to be taken under the procedures; (iii) an acquiring fund purchases shares of an unregistered money market fund only if the unregistered fund's adviser determines on an ongoing basis that the unregistered money market fund is in compliance with rule 2a-7 and preserves for a period of not less than six years from the date of determination, the first two years in an easily accessible place, a record of the determination and the basis on which it was made, and the record is subject to examination by Commission staff; (iv) the unregistered money market fund complies with the requirements of sections 17(a), (d), and (e), 18, and 22(e) of the Act as if it were a registered open-end fund; (v) the investment adviser to the unregistered money market fund adopts procedures designed to ensure that the fund complies with those provisions of the Act, periodically reviews and updates as appropriate the procedures, and maintains books and records describing those procedures; (vi) the investment adviser to the unregistered money market fund maintains the records required by rules 31(a)-1(b)(1), 31a-1(b)(ii)(2), and 31a-1(b)(9) under the Act for a period of not less than six years from the end of the fiscal year in which any transaction occurred, the first two years in an easily accessible place and subject to examination by Commission staff; (vii) the net asset value per share with respect to unregistered money market fund shares is determined by dividing the value of the assets belonging to the fund, less the liabilities of the fund, by the number of outstanding shares of the fund; (viii) the acquiring fund purchases and redeems shares of the unregistered money market fund as of the same time and at the same price, and receives dividends and bears its proportionate share of expenses on the same basis, as other shareholders of the unregistered money market fund; and (ix) a separate account is established in the shareholder records of the unregistered money market fund for the account of the acquiring fund.

<sup>120</sup> The orders permitting affiliated funds of funds to invest in funds outside the fund group have required that the acquiring fund's board of directors, including the independent directors, must find that the fees charged under the acquiring fund's advisory contract are based on services that are not duplicative of services provided under any acquired fund's advisory contract.

## 1. Benefits

Proposed rule 12d1-1 would codify our orders that permit a fund to acquire an unlimited number of shares of a registered money market fund. The proposed rule would retain only one condition included in the orders: no sales load, distribution-related fees, or service fees could be imposed on the acquisition of money market fund shares unless the adviser waived an equivalent amount of its fee. The proposed rule would not limit a fund to investing 25 percent of its assets in a money market fund. We believe that any restrictions on an acquiring fund's investments in money market funds should be governed by the fund's investment policies and limitations. Consequently, the proposed rule may provide some additional flexibility to certain funds. We do not know whether many funds are likely to invest more than 25 percent of their assets in money market funds as a result of this change, and we seek comment on the issue.

Under the proposed rule, funds also would be allowed to invest in money market funds advised by a different adviser. We believe that this would allow all funds, particularly small funds without a money market fund in their fund group, the opportunity currently available to large funds to acquire money market fund shares. This might allow smaller funds to be more competitive with larger funds. We seek comment on whether many funds are likely to invest in money market funds outside their fund group.<sup>121</sup>

Proposed rule 12d1-1 also would codify our orders permitting funds to invest cash in unregistered money market funds that comply with rule 2a-7. The proposed rule would require the acquiring fund to "reasonably believe" that the unregistered money market fund operates in compliance with rule 2a-7, complies with certain provisions of the Act,<sup>122</sup> as well as other requirements. This standard is slightly different than the condition in our exemptive orders, which requires the acquired fund's compliance with rule 2a-7 and certain provisions of the Act. An acquiring fund could "reasonably believe" that an acquired fund is complying with these provisions even if there is a minor or inadvertent violation of one by the acquired fund. In those circumstances, the violation would not

<sup>121</sup> The other conditions included in our exemptive orders are addressed by requirements under the Act and rules thereunder. Thus, we do not believe that any benefits or costs are associated with eliminating those conditions in the proposed rule.

<sup>122</sup> See *supra* note 119.

cause the acquiring fund to lose its exemption, while a strict standard of compliance could result in the acquiring fund's loss of the exemption. The proposed rule does not include certain conditions imposed in the orders that we believe are addressed by other provisions of the Act or rules thereunder, and with which the unregistered fund would have to comply.

Proposed rule 12d1-2 would codify our exemptive orders that permit an affiliated fund of funds to acquire securities issued by a fund in a different fund group under section 12(d)(1)(F) or 12(d)(1)(A). The proposed rule also would permit an affiliated fund of funds to acquire securities not issued by a fund. An affiliated fund of funds that invests in another fund under section 12(d)(1)(A) or (F) could acquire no more than 3 percent of the shares of any acquired fund in a different fund group. An acquiring fund that invests in securities issued by a fund in a different group under section 12(d)(1)(A) could invest no more than 5 percent of its assets in any one fund in a different group, or 10 percent of its assets in funds in a different group (or groups) in the aggregate. A fund that acquires securities under section 12(d)(1)(F) would not be limited in the amount of assets it could invest in funds in a different fund group. The acquiring fund would, however, be limited to charging a 1½ percent sales load on its shares, subject to voting restrictions with respect to acquired fund securities, and limited in the amount of an acquired fund's securities it could redeem in any period of less than 30 days.<sup>123</sup> The proposed rule would allow funds to choose from one of two sets of conditions under which they may invest in funds outside the fund group. We believe that there may be benefits to permitting funds the ability to invest under either section, whichever may be more beneficial to the fund, and we seek comment on this issue.

Proposed rule 12d1-3 codifies the exemptive orders we have issued permitting funds relying on section 12(d)(1)(F) to charge a sales load in excess of 1½ percent, provided the aggregate sales load and distribution fees on acquiring and acquired fund shares are not excessive under the NASD Sales Charge Rule. This exemption also would be available to an affiliated fund of funds relying on proposed rule 12d1-2 to invest in funds in a different fund group.<sup>124</sup> We seek

comment on the benefits and costs of this proposal.

We anticipate that funds and their shareholders would benefit from the proposed rules. As discussed above, funds increasingly have sought exemptive orders (which the Commission has granted) to engage in most of the activities the proposed rules would 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 proposed rules would benefit funds and their shareholders by eliminating the direct costs of applying to engage in activities permitted under the rule.<sup>125</sup> The proposed rules would further benefit funds by eliminating the uncertainty that a particular applicant might not obtain relief to engage in the activities permitted under the proposed rules.

The exemptive application process also involves other indirect costs. Funds that apply for an order to permit additional investments forego beneficial investments until they receive the order, while other funds forego the investment entirely rather than seek an exemptive order because the cost 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 consistently exceeds the potential benefit.

## 2. Costs

We do not believe that the proposed rules would impose mandatory costs on any fund. As discussed above, the rules are exemptive, and we believe that no fund would rely on any of them if the benefits did not outweigh the costs of relying on the rule.

We believe the costs of relying on the proposed rules would be the same as or less than the costs to a fund that relies on an existing exemptive order because

<sup>123</sup> For example, in calendar years 2001 and 2002, 24 funds sought exemptive relief to invest uninvested cash and/or cash collateral from securities lending activities in money market funds, and 8 of those funds also sought exemptive relief to invest cash collateral in unregistered money market funds. In the past 5 years, 13 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, 11 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. The cost to a fund for submitting one of these applications ranges from approximately \$7,000 to \$67,000. These figures are based on conversations with attorneys and fund employees who have been involved in submitting applications to the Commission.

each of the proposed rules includes the same or fewer conditions than existing orders that provide equivalent exemptive relief.<sup>126</sup> As noted earlier, we assume a fund would only bear the costs of obtaining and complying with an order if the benefits of the order outweighed those costs.

The rule will affect different types of funds in different ways. For a fund that has not sought and would not seek exemptive relief from the statute, the proposed rules would have no effect. For a fund that currently relies on an exemptive order there may be one-time "learning costs" in determining the difference between the order and the rule. After making this determination, the costs of relying on any of the rules would be the same as or less than the costs of relying on an order providing similar exemptive relief. In addition, a fund that currently relies on an exemptive order could satisfy all the conditions of any of the proposed rules that provide similar exemptive relief without changing its operation. In the case of rule 12d1-1, the fund would simply be satisfying conditions that are no longer required.

A fund that has not relied on an exemptive order and that intends to rely on one of the proposed rules in the future would have to determine how that rule fits into the fund's business model and the potential costs associated with complying with the rule. Nevertheless, if the Commission never promulgated the rule, those funds would bear the same costs if they considered applying for an exemptive order. Moreover, in the absence of the proposed rules, if these funds applied for exemptive orders and obtained them, their total costs would be the same as or greater than the costs associated with the proposed rules.

## B. Proposed 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 proposed amendments to Form N-1A would require a registered

<sup>126</sup> Under the current system, a fund could obtain the proposed relief by obtaining an exemptive order and complying with the conditions in the order, and a fund incurs costs in obtaining exemptive relief under this system. Our analysis compares the costs a fund would bear to comply with the proposed rules with the costs a fund would bear under the current system to obtain equivalent exemptive relief. Because the conditions in the proposed 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.

<sup>123</sup> See *supra* note 114.

<sup>124</sup> See *supra* note 123 and accompanying text.

open-end fund that invests in other funds to include a line item in its fee table, under the fund's annual operating expenses, that lists the aggregate fees and costs of acquired funds. The proposed amendment to Form N-2 would require registered closed-end funds that invest in other funds to provide the same disclosure. The proposed amendment to Form N-3 would require the same disclosure for separate accounts organized as management investment companies that offer variable annuity contracts. The proposal includes instructions on calculating the fees and operating costs of acquired funds. The calculation would aggregate indirect operating expenses of acquired funds and transaction costs and express them as a percentage of average net assets of the acquiring fund.

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 proposed amendment to each of these forms would require 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 N-4 or 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 proposed amendments to Forms N-1A, N-2, N-3, N-4, and N-6 would 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. We have no means by which to quantify these benefits, however. We seek comment on the benefits of the proposed amendments (and any alternatives suggested by commenters) as well as any data quantifying those benefits.

#### 2. Costs

The proposed amendments to Forms N-1A, N-2, N-3, N-4, and N-6 would 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 proposal would require a new disclosure to the annual operating expense item in the fee table for funds that invest in other funds. It also would require separate accounts organized as UITs that offer variable annuity and variable life contracts to include an additional expense in its calculation of annual portfolio company operating expenses. The costs of the proposed disclosures would 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 proposed disclosures would add a single line item to the fee table for funds that invest in other funds. In the context of the prospectus, we believe that the external costs of including this additional line of disclosure per registered fund would be minimal. With respect to Forms N-4 and N-6, the proposal would 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.

Second, for purposes of the Paperwork Reduction Act, Commission staff has estimated that the disclosure requirement for calculating the line item according to the proposed instructions would add up to 7 hours to the burden of completing Forms N-1A, N-2, and N-3. Thus, we estimate that the additional annual cost of including the line item per portfolio would equal \$410.<sup>127</sup> Commission staff also has 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, for an annual cost per portfolio of \$15.<sup>128</sup> Commission staff estimates that there are 224 fund of

<sup>127</sup> Commission staff estimated the cost to equal six hours for an intermediate-level accountant at \$30 per hour to perform the calculation and one hour for a deputy general counsel at \$230 per hour to review the calculation ( $(6 \times \$30) + (1 \times \$230) = \$410$ ).

<sup>128</sup> Commission staff estimated the cost to equal one-half hour for an intermediate level accountant to include the expense item in the calculation. The estimated cost is based on the following calculation:  $0.5 \times \$30 = \$15$ .

funds portfolios.<sup>129</sup> Accordingly, we estimate that, at a minimum, the total annual internal costs of complying with the proposed form amendments would equal \$92,000.<sup>130</sup> In addition, Commission staff estimates that half the funds registered under Forms N-1A and N-2 invest in other funds, and 5 separate accounts (with 7 portfolios) registered under Form N-3 invest in other funds and would be required to make the proposed disclosure on an annual basis.<sup>131</sup> For purposes of the Paperwork Reduction Act analysis, Commission staff has estimated that on an annual basis, registrants file (i) initial registration statements covering 483 portfolios and post effective amendments covering 6,542 portfolios on Form N-1A, (ii) 234 initial registration statements and 38 post-effective amendments on Form N-2, and (iii) initial registration statements covering 12 portfolios and post-effective amendments covering 152 portfolios on Form N-3. In addition, Commission staff also estimates that each year, 157 separate accounts file initial registrations and 1,242 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>132</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 proposed amendments to Forms N-1A, N-2, N-3, N-4, and N-6 using the calculation in the proposed instructions would be \$1.5 million.<sup>133</sup>

We do not know the number of funds that would be likely to begin investing in other funds under the proposed rules.

<sup>129</sup> The estimate of fund of funds portfolios is based on information gathered from Morningstar, Inc.

<sup>130</sup> The estimate is based on the following calculation:  $224 \text{ portfolios} \times \$410 = \$91,840$ .

<sup>131</sup> See *infra* notes 139, 145, 151, and accompanying text.

<sup>132</sup> Of these post-effective amendments, 150 are updates and 350 are additional post-effective amendments. Separate accounts file initial post-effective amendments to update their financial statements and provide any other material updates. The additional post-effective amendments generally are filed pursuant to Securities Act rule 485(b) to make non-material changes to the registration statement and are generally more limited and much simpler to prepare than post-effective amendments filed as annual updates. We assume that registered funds would include the proposed disclosure only in a post-effective amendment for the annual update.

<sup>133</sup> The estimate is based on the following calculation:  $((483 + 6,542/2) \times \$410) + ((234 + 38/2) \times \$410) + (7 \text{ separate account portfolios} \times \$410) + ((157 + 1,242/2) \times \$15) + (200 \text{ separate accounts} / 2 \times \$15) = \$1,510,747.5$ .

Accordingly, we seek comment as to how many funds that do not now invest in other funds, would invest in funds under the proposed rules and be required to report the expenses of acquired funds under the proposed form amendments.

### C. Request for Comments

The Commission requests comment on the potential costs and benefits identified in the proposal and any other costs or benefits that may result from the proposal. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,<sup>134</sup> we also request comment regarding the potential impact of the proposed rule on the economy on an annual basis. Commenters are requested to provide data to support their views.

## V. Paperwork Reduction Act

Proposed rule 12d1-1 would impose a new "collection of information" requirement within the meaning of the Paperwork Reduction Act of 1995.<sup>135</sup> If adopted, this collection of information would not be mandatory. In addition, the Commission is proposing amendments to certain forms that currently contain "collection of information" requirements. The title of the new collection is "Rule 12d1-1." The titles for the existing collections are: (i) "Form N-1A under the Investment Company Act of 1940 and Securities Act of 1933, Registration Statement of Open-End Management Companies;" (ii) "Form N-2—Registration Statement of Closed-End Management Investment Companies;" (iii) "Form N-3—Registration Statement of Separate Accounts Organized as Management Investment Companies;" (iv) "Form N-4—Registration Statement of Separate Accounts Organized as Unit Investment Trusts;" and (v) "Form N-6—Registration Statement of Separate Accounts Organized as Unit Investment Trusts that Offer Variable Life Insurance Policies." 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.

The Commission has submitted these proposals to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. OMB has not yet assigned a control number to the new collection for proposed rule 12d1-1.

### A. Proposed Rule 12d1-1

Proposed rule 12d1-1 would permit a fund to invest in registered money market funds and in unregistered money market funds that meet certain conditions in excess of the limits of section 12(d)(1). A registered fund may invest in an unregistered money market fund as long as the unregistered money market fund (i) is limited to investing in the types of securities and other investments in which a money market fund may invest under rule 2a-7; and (ii) undertakes to comply with all other requirements of rule 2a-7. In addition, the acquiring fund must reasonably believe that the unregistered money market fund (i) operates in compliance with rule 2a-7; (ii) complies with sections 17(a), (d), (e), 18, and 22(c) of the Act; (iii) has adopted procedures to ensure that it complies with these statutory provisions; and maintains records to describe those procedures; (iv) maintains the records required under rules 31a-1(b)(1), 31a-1-1(b)(2)(ii), 31a-1(b)(2)(iv), and 31a-1(b)(9) under the Act; and (v) preserves those records permanently, the first two years in an easily accessible place. Rule 2a-7 contains certain collection of information requirements. In addition, the recordkeeping requirements under rule 31 are collections of information. We believe that this exemptive rule will provide funds greater options for cash management. We believe that unregistered money market funds must comply with certain collection of information requirements for registered money market funds to ensure that unregistered money market funds have established procedures for collecting the information necessary to make adequate credit reviews of securities in their portfolios, as well as other recordkeeping requirements that will assist the acquiring fund (and Commission staff in its examination of the unregistered money market fund's adviser) in overseeing the unregistered money market fund.

Based on exemptive orders issued by the Commission, Commission staff estimates that registered funds currently invest in 35 unregistered money market funds in excess of the limits imposed by section 12(d)(1).<sup>136</sup> Under the terms of the exemptive orders, those unregistered money market funds must comply with the requirements of rule 2a-7. Commission staff also estimates that 4

new unregistered money market funds would be established each year that would have to meet the requirements of the proposed rule. We seek comments on these estimates. For purposes of the Paperwork Reduction Act requirements, Commission staff has estimated that a registered money market fund each year spends an average of approximately 539 hours of professional time to record credit risk analyses and determinations regarding adjustable rate securities, asset-backed securities and securities subject to a demand feature or guarantee. Commission staff also estimated that in the first year of operation the board of directors, counsel, and staff of a new registered money market fund spend 38.5 hours to formulate and establish written procedures for stabilizing the fund's NAV and guidelines for delegating certain of the board's responsibilities to the fund's adviser.<sup>137</sup> Based on this estimate, Commission staff estimates the annual hour burden of the proposed rule's paperwork requirements for unregistered money market fund compliance with rule 2a-7 would be 21,175 hours.<sup>138</sup>

Rules 31a-1(b)(1), 31a-1(b)(2)(ii), 31a-1(b)(2)(iv), and 31a-1(b)(9) require registered funds to keep certain records, which include journals and general and auxiliary ledgers, including ledgers for each portfolio security and each shareholder of record of the fund. Most of the records required to be maintained by the rule are the type that generally would be maintained as a matter of good business practice and to prepare the unregistered money market fund's

<sup>137</sup> These estimates were included in the Commission's most recent Paperwork Reduction Act submission for approval of the collection of information burden for rule 2a-7. The estimates are based on discussions with individuals at money market funds and their advisers who responded to a random survey of 9 money market funds. The actual number of burden hours for credit risk analyses and determinations regarding adjustable rate securities, asset backed securities, and securities subject to a demand feature or guarantee may vary significantly depending on the type and number of portfolio securities held by the individual fund.

In addition, in its Paperwork Reduction Act submission, Commission staff estimated that in a year, only 0.3% of registered money market funds spends 0.5 hours to record board determinations and actions in response to certain events of default or insolvency, and to notify the Commission of the event. We have not included this burden estimate in our estimate for unregistered funds because 0.3 percent of 35 unregistered money market funds is less than 1.

<sup>138</sup> This estimate is based on the following calculation: (35 unregistered money market funds × 539 hours) + (4 new unregistered money market funds × (539 + 38.5 hours)) = 21,175. To the extent that unregistered money market funds would keep these records in any case as a matter of good business practice, this estimate may be greater than the actual annual burden.

<sup>134</sup> Pub. L. No. 104-113, Title II, 109 Stat. 163 (1995).

<sup>135</sup> 44 U.S.C. 3501 to 3520.

<sup>136</sup> This estimate may be understated because applicants generally do not identify the unregistered money market funds in which registered funds will invest, and exemptive orders provide relief for unregistered money market funds that may be organized in the future.

financial statements. Accordingly, Commission staff estimates 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 these 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 custom.

### B. Forms for Registration Statements

We are proposing amendments to require registered open-end and closed-end funds, and separate accounts organized as management investment companies that invest in other funds to disclose aggregate fees of acquired funds. The disclosure would be a line item appearing under the item for annual operating expenses of the fund. We also are proposing that separate accounts organized as UITs that invest in portfolio companies that themselves invest in other funds, include the costs of investing in those other funds in the disclosure on portfolio companies' operating expenses. We believe that the proposed amendments will enable shareholders to understand better the expenses of acquired funds and to compare overall costs of investing in a fund of funds with the costs of an alternative fund of funds, and with the costs of a more traditional fund.

#### 1. Form N-1A

Form N-1A (OMB Control No. 3235-0307), including the proposed amendment, contains collection of information requirements. The likely respondents to this information collection are open-end funds registering with the Commission on Form N-1A. Compliance with the disclosure requirements of Form N-1A is mandatory. Responses to the disclosure requirements are not confidential.

The current burden for preparing an initial Form N-1A filing is 809 hours per portfolio. The current annual hour burden for preparing post-effective amendments on Form N-1A is 101 hours per portfolio. The Commission estimates that, on an annual basis, registrants file initial registration statements covering 483 portfolios, and post-effective amendments covering 6,542 portfolios on Form N-1A.<sup>139</sup>

<sup>139</sup> These estimates are based on information in the Commission's filing database and from Morningstar databases. They assume that of the 3,075 registered open-end funds, 179 registrants will file an initial registration statement and 2,423 registrants will file one post-effective amendment

Thus, the Commission estimates that the current total annual hour burden for the preparation and filing of Form N-1A is 1,051,489.<sup>140</sup>

We estimate that a line item prepared according to the proposed instructions would increase the hour burden per portfolio per filing of an initial registration or a post-effective amendment to a registration statement by 7 hours.<sup>141</sup> Commission staff estimates that 1/2 of funds registered under Form N-1A invest in another fund, and would be required to make the proposed disclosure.<sup>142</sup> We seek comment on these estimates. Thus, if the proposed amendments to Form N-1A instructions were adopted, the total annual hour burden for all funds for preparation and filing of initial registration statements and post-effective amendments to Form N-1A would be 1,076,080.<sup>143</sup>

#### 2. Form N-2

Form N-2 (OMB Control No. 3235-0026), including the proposed amendment, contains collection of information requirements. The likely respondents to this information collection are closed-end funds registering with the Commission on Form N-2. Compliance with the disclosure requirements of Form N-2 is mandatory. Responses to the disclosure requirements are not confidential.

The current burden for preparing an initial Form N-2 filing is 544.7 hours per fund.<sup>144</sup> The current burden for preparing a post-effective amendment on Form N-2 is 103.7 hours. Commission staff estimates that an average of 234 closed-end funds file an initial registration statement and 38 file a post-effective amendment on Form N-2 each year.<sup>145</sup> Thus, the Commission estimates that the current annual hour burden for preparing an N-2 is 131,400.<sup>146</sup>

with material differences each year with an average of 2.7 portfolios per registrant.

<sup>140</sup> This estimate is based on the following calculation:  $((483 \times 809) + (6,542 \times 101) = 1,051,489)$ . The total annual hour burden approved for N-1A is 916,162. The increase over the approved annual burden is due to an increase in the number of registrants filing initial registration statements on Form N-1A.

<sup>141</sup> See *supra* note 119.

<sup>142</sup> This is based on information in the Commission's database of Form N-SAR filings.

<sup>143</sup> This estimate is based on the following calculation:  $(1,051,489 + (483/2 \times 7) + (6,542/2 \times 7)) = 1,076,080$ .

<sup>144</sup> Initial registration statements and post-effective amendments filed on Form N-2 generally cover only one portfolio.

<sup>145</sup> This estimate is based on information in the Commission's database.

<sup>146</sup> This estimate is based on the following calculation:  $((234 \times 544.7) + (38 \times 103.7) =$

Commission staff estimates that it would take the same amount of time to prepare the line item disclosure in Form N-2 as it would to prepare the disclosure in Form N-1A (see previous discussion). As with funds registered under Form N-1A, we are assuming that 1/2 of funds registered under Form N-2 invest in another fund, and would be required to make the proposed disclosure. We seek comment on those numbers. Accordingly, if the proposed amendments to Form N-2 were adopted, we estimate the total annual hour burden for all funds for preparation and filing of initial registration statements and post-effective amendments to Form N-2 would be 132,352.<sup>147</sup>

#### 3. Form N-3

Form N-3 (OMB Control No. 3235-0316), including the proposed amendment, contains collection of information requirements. The likely respondents to this information collection are separate accounts organized as management investment companies registering with the Commission on Form N-3. Compliance with the disclosure requirements of Form N-3 is mandatory. Responses to the disclosure requirements are not confidential.

The current burden for preparing an initial Form N-3 filing is 915.2 hours per portfolio. The current burden for preparing a post-effective amendment on Form N-3 is 150.4 hours per portfolio. Commission staff estimates that 3 initial registrations and 38 post-effective amendments are filed annually with an average of 4 portfolios per filing, for a total of 12 portfolios covered by initial registrations and 152 portfolios covered by post-effective amendments annually.<sup>148</sup> Thus, the Commission estimates that the current annual hour burden for preparing an N-3 is 33,843.<sup>149</sup>

We estimate that it would take the same amount of time to prepare a line item according to the proposed instructions in Form N-3, as in Forms N-1A and N-2. Thus we estimate the

131,400.4). The total annual hour burden approved for Form N-2 is 80,198.6. The increase is due to an increase in the number of initial registration statements filed on Form N-2.

<sup>147</sup> This estimate is based on the following calculation:  $(131,400 + (234/2 \times 7) + (38/2 \times 7) = 132,352)$ .

<sup>148</sup> This estimate is based on information in the Commission's database.

<sup>149</sup> This estimate is based on the following calculation:  $(12 \text{ portfolios} \times 915.2) + (152 \text{ portfolios} \times 150.4 \text{ hours}) = 33,843.2$ . The total annual hour burden approved for Form N-3 is 36,096. The decrease is due to a decrease in the number of post-effective amendments filed on Form N-3.

proposed line item would increase the hour burden per portfolio per filing of an initial registration or a post-effective amendment to a registration statement by 7 hours.<sup>150</sup> Commission staff estimates that 5 registrants with 7 portfolios registered on Form N-3 invest in another fund, and would be required to make the proposed disclosure.<sup>151</sup> We seek comment on these numbers. Thus, if the proposed amendments to Form N-3 instructions were adopted, the Commission estimates that the total annual hour burden for all funds for preparation and filing of initial registration statements and post-effective amendments to Form N-3 would be 33,934.<sup>152</sup>

#### 4. Form N-4

Form N-4 (OMB Control No. 3235-0318), including the proposed amendments, contains collection of information requirements. The likely respondents to this information collection are separate accounts organized as UITs that offer variable annuity contracts registering with the Commission on Form N-4. Compliance with the disclosure requirements of Form N-4 is mandatory. Responses to the disclosure requirements are not confidential.

The current burden for preparing an initial registration on Form N-4 is 273.2 hours per separate account. The current annual burden for preparing a post-effective amendment on Form N-4 is 195 hours per separate account. Commission staff estimates that an average of 157 separate accounts organized as UITs that offer variable annuity contracts file an initial registration statement and 1,242 file a post-effective amendment on Form N-4 each year.<sup>153</sup> Thus, the Commission estimates that the current annual hour burden for preparing an N-4 is 285,082.<sup>154</sup>

Commission staff estimates that it would take 1/2 hour to include in the disclosure of total annual portfolio company operating expenses, the line item from the portfolio company's prospectus disclosing acquired fund fees and expenses. We estimate that 1/2 of separate accounts registering on Form

N-4 invest in portfolio companies that invest in other funds, and would be required to make the proposed disclosure.<sup>155</sup> We seek comment on those numbers. Accordingly, if the proposed amendments to Form N-4 were adopted, the total annual hour burden for all funds for preparation and filing of initial registration statements and post-effective amendments to Form N-4 would be 285,432.<sup>156</sup>

#### 5. Form N-6

Form N-6 (OMB Control No. 3235-0503), including the proposed amendments, contains collection of information requirements. The likely respondents to this information collection are separate accounts organized as UITs that offer variable life insurance contracts registering with the Commission on Form N-6. Compliance with the disclosure requirements of Form N-6 is mandatory. Responses to the disclosure requirements are not confidential.

The current burden for preparing an initial registration on Form N-6 is 765 hours. The current annual burdens for preparing a post-effective amendment for an annual update and an additional post-effective amendment on Form N-6 are 65 hours and 10 hours, respectively.<sup>157</sup> Commission staff estimates that an average of 50 initial registration statements, 150 post-effective amendments for an annual update, and 350 additional post-effective amendments will be filed by variable life insurance policies issued by separate accounts on Form N-6 each year.<sup>158</sup> Thus, the Commission estimates that the current annual hour burden for preparing Form N-6 is 51,500.<sup>159</sup>

Commission staff estimates that it would take 1/2 hour to include in the disclosure of total annual portfolio company operating expenses, the line item from the portfolio company's prospectus disclosing acquired fund fees and expenses. We estimate that 1/2

of separate accounts registering on Form N-6 invest in portfolio companies that invest in other funds, and would be required to make the proposed disclosure.<sup>160</sup> We seek comment on those numbers. Accordingly, if the proposed amendments to Form N-6 were adopted, the total annual hour burden for all funds for preparation and filing of initial registration statements and post-effective amendments to Form N-6 would be 51,550.<sup>161</sup>

#### C. Request for Comments

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (i) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) evaluate whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements of the proposed rules and form amendments should direct them to the Office of Management and Budget, Attention Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20503, and should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609, with reference to File No. S7-18-03. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this Release; therefore a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-18-03, and be submitted to the Securities and Exchange Commission, Records

<sup>155</sup> Commission staff estimates that each portfolio would be required to include the disclosure either in one initial registration or post-effective amendment each year.

<sup>156</sup> This estimate is based on the following calculation:  $(285,082.4 + (157/2 \times 0.5) + (1,242/2 \times 0.5)) = 285,432.2$ .

<sup>157</sup> The hour burden for filing additional post-effective amendments is significantly less than that for the post-effective amendment for the annual update. See *supra* note 132.

<sup>158</sup> This estimate is based on information in the Commission's database.

<sup>159</sup> This estimate is based on the following calculation:  $(50 \times 765) + (150 \times 65) + (350 \times 10) = 51,500$ . The total annual hour burden approved for Form N-6 is 61,135. The approved burden was based on estimates of filings at the time Form N-6 was proposed, and was not based on actual form filings.

<sup>160</sup> Commission staff estimates that each portfolio would be required to include the disclosure either in an initial registration or post-effective amendment each year.

<sup>161</sup> This estimate is based on the following calculation:  $(51,500 + (50/2 \times 0.5) + (150/2 \times 0.5)) = 51,550$ .

<sup>150</sup> See *supra* note 127.

<sup>151</sup> This estimate is based on information in the Commission's database of Form N-SAR filings.

<sup>152</sup> This estimate is based on the following calculation:  $33,843 + (7 \times 7) + (12/2 \times 7) = 33,934$ .

<sup>153</sup> This estimate is based on information in the Commission's database.

<sup>154</sup> This estimate is based on the following calculation:  $(157 \times 273.2) + (1242 \times 195) = 285,082.4$ . The total annual hour burden approved for Form N-4 is 300,292. The decrease is due to a decrease in the number of registrants filing post-effective amendments on Form N-4.

Management, Office of Filings and Information Services, 450 Fifth Street, NW., Washington, DC 20549.

## VI. 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>162</sup>

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

Proposed 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 proposed rules will promote efficiency and competition. Proposed rule 12d1-1 would permit funds to acquire shares of money market funds in the same or in a different fund group in excess of the limitations in section 12(d)(1). This exemption should allow 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. Proposed rule 12d1-2 would permit 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, as well as permit a traditional equity or bond fund to invest in funds within the same fund complex. We believe that this expansion of investment opportunities also will permit funds to allocate their investments more efficiently. The effects of the proposed rules on capital formation are unclear.

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

The proposed form amendments are intended to provide better transparency for fund shareholders with respect to the costs of investing in funds of funds. The enhanced disclosure requirements would 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 proposed amendments may also improve competition, as enhanced disclosure may prompt funds to provide improved products and services that may have a greater appeal to better-informed investors. Enhanced disclosure also may prompt acquiring funds to invest in acquired funds with lower costs. Finally, the effects of the proposed amendments on capital formation are unclear. Although, as noted above, we believe that the proposed amendments would benefit investors, the magnitude of the effect of the proposed amendments on efficiency, competition, and capital formation is difficult to quantify, particularly given that most funds do not currently provide the type of disclosure contemplated by the proposed amendments.

### C. Request for Comment

We request comment on whether the proposed rules and form amendments, if adopted, would promote efficiency, competition, and capital formation. We also request comment on whether the proposed rules and form amendments, if adopted, would impose a burden on competition. Commenters are requested to provide empirical data and other factual support for their views, if possible.

## VII. Summary of Initial Regulatory Flexibility Analysis

We have prepared an Initial Regulatory Flexibility Analysis ("IRFA") under 5 U.S.C. 603 regarding proposed rules 12d1-1, 12d1-2, and 12d1-3, and proposed amendments to Forms N-1A, N-2, N-3, N-4, and N-6 under the Investment Company Act. The following summarizes the IRFA. The IRFA summarizes the reasons, objectives, and legal basis for the proposed rules and form amendments. The IRFA also discusses the effect of the proposed rules and form amendments on small entities. The staff estimates, based upon Commission filings, that there are approximately 5,025 active registered funds and 48 business development companies, of which approximately 209 and 28 are small entities, respectively.<sup>163</sup> The staff

<sup>163</sup> 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. Rule 0-10 [17 CFR 270.0-10]. The number of small entities is derived from analyzing information from databases such as Morningstar, Inc. and Lipper. Some or all of these entities may contain multiple series or portfolios, which are also small entities.

estimates that few, if any, registered separate accounts are small entities. Funds that are small entities, like other funds, may rely on the proposed rules if they satisfy the conditions. Under the proposed form amendments, a fund that invests in another fund would be required to disclose the aggregate expenses of acquired funds.

We believe that the proposed rules would have little impact on small entities. Like other funds, small entities would be affected by the proposed rules only if they determined to use the exemptions provided under the proposed rules. Few small entities have applied for relief to engage in the activities that would be permitted under the proposed rules.<sup>164</sup> The proposed amendments to Forms N-1A and N-2 would likely have a greater impact on small entities.

As noted above, compliance with the proposed rules is voluntary, and therefore the proposed rules would not impose mandatory reporting or recordkeeping requirements and would not materially increase other compliance requirements. No federal rules duplicate or conflict with the proposed rules. The Commission is seeking comment on the proposed amendments to Forms N-1A, N-2, N-3, N-4, and N-6. Commission staff has estimated that the burden per small fund portfolio would be up to 7 hours, at a cost of \$410.<sup>165</sup> Assuming half of small funds invest in other funds and were required to comply with the form amendments, we estimate the annual disclosure cost for small entities would be \$93,685.<sup>166</sup>

We have considered significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. We considered: (a) Differing compliance or reporting requirements or

<sup>164</sup> If the rules were adopted more small entities may use the relief provided, but the number of small entities engaging in these activities would probably remain small.

<sup>165</sup> If each portfolio of a registered fund includes the proposed disclosure, staff estimates the disclosure required by the proposed instructions would take up to 6 hours for an intermediate accountant at a rate of \$30 per hour plus one hour for a deputy general counsel at a rate of \$230 per hour to perform ((6 × \$30) + (1 × \$230) = \$410). See Securities Industry Association, *Report on Management and Professional Earnings in the Securities Industry* (2002).

<sup>166</sup> There are 157 small funds registered under Form N-1A, with an average of 2.7 portfolios per registrant. There are 33 small funds registered under Form N-2, with an average of 1 portfolio per registrant. Thus, Commission staff estimates there are a total of 457 portfolios ((157 × 2.7) + 33 = (423.9 + 33) = 456.9) reporting under Forms N-1A and N-2. The estimate of annual disclosure cost is based on the following calculation: 457/2 portfolios × \$410 = \$93,685.

<sup>162</sup> 15 U.S.C. 80a-2(c).

timetables that take into account the resources available to small entities; (b) clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (c) performance rather than design standards; and (d) an exemption from coverage of the rule, or any part thereof, for small entities. The rule requirements, as explained above, are designed to protect the interests of all fund investors, and an exemption from the conditions in the proposed rules for small entities would not be consistent with the protection of investors. Further clarification, consolidation, or simplification of the requirements is not necessary. The conditions of the rules are design rather than performance standards.

We encourage comment on the IRFA, especially with regard to the number of small entities that are likely to rely on the proposed rules and the impact of the proposed form amendments on small entities. A copy of the IRFA is available from Penelope W. Saltzman, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549-0506.

### VIII. Statutory Authority

The Commission is proposing 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 Investment Company Act [15 U.S.C. 80a-6(c), 80a-12(d)(1)(J), 80a-37(a)]. The Commission is proposing amendments to registration forms under the authority set forth in sections 6, 7(a), 10 and 19(a) of the Securities Act of 1933 [15 U.S.C. 77f, 77g(a), 77j, 77s(a)], and sections 8(b), 24(a), and 30 of the Act [15 U.S.C. 80a-8(b), 80a-24(a), and 80a-29].

#### 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 Proposed Rules and Form Amendments

For the reasons set out in the preamble, the Commission proposes to amend Title 17, Chapter II of the Code of Federal Regulations to read as follows:

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

1. 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).  
\* \* \* \* \*

2. 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.* If the conditions of paragraph (b) of this section are satisfied, notwithstanding sections 12(d)(1)(A), 12(d)(1)(B), and 17(a) of the Act (15 U.S.C. 80a-12(d)(1)(A), 80a-12(d)(1)(B), and 80a-17(a)), 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 therefor, 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) *Administrative fees.* The Acquiring Fund pays no Administrative Fees, or the Acquiring Fund’s investment adviser waives its advisory fee in an amount necessary to offset any Administrative Fees.

(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:

(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)) as if it were a registered open-end investment company; and

(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)) as if it were a registered open-end investment company, 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) *Definitions.*

(1) *Administrative Fees* means any sales charge, as defined in rule 2830(b)(8) of the Conduct Rules of the NASD, 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.

(2) *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)).

(3) *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, 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(c)(3).

**§ 270.12d1-3 Exemptions for investment companies relying on section 12(d)(1)(F) of the Act.**

(a) *Exemption from sales charge limits.* A registered investment company (“Acquiring 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 Company”) 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 Company’s securities, when aggregated with the sales charges and service fees charged with respect to the Acquired Company’s securities, do not exceed the limits set forth in rule 2830 of the Conduct Rules of the National

Association of Securities Dealers, Inc. 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 is attributed to those terms in rule 2830(b) of the National Association of Securities Dealers, Inc. Rules.

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

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

3. 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, 77sss, 78c, 78l, 78m, 78n, 78o(d), 78u-5, 78w(a), 78ll(d), 79e, 79f, 79g, 79j, 79l, 79m, 79n, 79q, 79t, 80a-8, 80a-24, 80a-26, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

\* \* \* \* \*

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. Item 3 of Form N-1A (referenced in §§ 239.15A and 274.11A) 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 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)).

(ii) Determine the “[Acquired Fund] Fees and Expenses” according to the following formula:

$$AFFE = \frac{[(F_1/365) * AI_1 * D_1] + [(F_2/365) * AI_2 * D_2] + [(F_3/365) * AI_3 * D_3] + \text{Transaction Fees}}{\text{Average Net Assets of the Fund}}$$

Where:

AFFE = Acquired Fund fee expense;  
 F<sub>1</sub>, F<sub>2</sub>, F<sub>3</sub>, . . . = Total annual fund operating expense ratio (gross) for each Acquired Fund;

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 shares in any Acquired Funds during the most recent fiscal year.

(iii) Calculate the average net assets of the Fund for the most recent fiscal year, as provided in Item 9(a) (see Instruction 4 to Item 9(a)).

(iv) If the Acquired Fund and the Fund are part of the same “group of

investment companies” (as defined in section 12(d)(1)(G)(ii) of the Investment Company Act (15 U.S.C. 80a-12(d)(1)(G)(ii))), the total annual expense ratio used for purposes of this calculation (F<sub>1</sub>) is the actual total annual expense ratio of the Acquired Fund for the Acquiring Fund’s most recent fiscal year. If the Acquired Fund and the Fund are not part of the same “group of investment companies,” the total annual expense ratio used for purposes of this calculation (F<sub>1</sub>) is: (A) the gross total annual fund operating expense ratio for the Acquired Fund’s most recent fiscal year disclosed in the financial highlights table of the Acquired Fund’s most recent semi-annual report filed with the Commission; or (B) in the case of an Acquired Fund that does not provide a gross total annual expense ratio in its semi-annual report or does

not file semi-annual reports with the Commission, the ratio of total annual operating expenses of the Acquired Fund to average total annual net assets of the Acquired Fund for its most recent fiscal year, as disclosed in the most recent communication from the Acquired Fund to the Fund. In each case, the total annual expense ratio used should not include the effect of waivers or reimbursements by the Acquired Funds’ investment advisers or sponsors. The Fund may disclose the AFFE determined based on the net expenses of the Acquired Funds in a footnote to the fee table.

(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 as of each month end 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 substitute the term used in the prospectus to refer to

the Acquired Funds for the bracketed portion of the caption provided.

\* \* \* \* \*

6. Item 3 of Form N-2 [referenced in §§ 239.14 and 274.11a-1] is amended by:

a. Redesignating paragraph 10 under the Instructions titled “Example” as paragraph 11; and

b. Adding new paragraph 10 before the heading “Example” to read 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**

\* \* \* \* \*

*Instructions*

\* \* \* \* \*

*Annual Expenses*

\* \* \* \* \*

10. 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 Registrant invests (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)).

b. Determine the “[Acquired Fund] Fee and Expenses” according to the following formula:

$$AFFE = \frac{[(F_1/365) * AI_1 * D_1] + [(F_2/365) * AI_2 * D_2] + [(F_3/365) * AI_3 * D_3] + \text{Transaction Fees}}{\text{Average Net Assets of the Registrant}}$$

Where:

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

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 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 4.1 (*see* Instruction 15 to Item 4).

d. If the Acquired Fund and the Registrant are part of the same “group of investment companies” (as defined in section 12(d)(1)(G)(ii) of the 1940 Act (15 U.S.C. 80a-12(d)(1)(G)(ii))), the total annual expense ratio used for purposes of this calculation (F<sub>1</sub>) is the actual total annual expense ratio of the Acquired Fund for the Acquiring Fund’s most recent fiscal year. If the Acquired Fund and the Registrant are not part of the same “group of investment companies,” the total annual expense ratio used for purposes of this calculation (F<sub>1</sub>) is: (A)

the total annual fund operating expense ratio for the Acquired Fund’s most recent fiscal year disclosed in the financial highlights table of the Acquired Fund’s most semi-annual report filed with the Commission; or (B) in the case of an Acquired Fund that does not provide a total annual expense ratio in its semi-annual report or does not file semi-annual reports with the Commission, the ratio of total annual operating expenses of the Acquired Fund to average total annual net assets of the Acquired Fund for its most recent fiscal year, as disclosed in the most recent communication from the Acquired Fund to the Registrant.

e. 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 as of each month end 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. Base the “[Acquired Fund] Fees and Expenses” on (i) assumptions about specific funds in which the Registrant expects to invest, and (ii) estimates of the amount of assets the Registrant expects to invest in each of those Acquired Funds with the proceeds of the offering.

g. The Registrant may substitute the term used in the prospectus to refer to the Acquired Funds for the bracketed portion of the caption provided.

\* \* \* \* \*

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

a. Redesignating paragraph 19 under the Instructions titled “Example” as paragraph 20; and

b. Adding new paragraph 19 before the heading “Example” to read 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**

\* \* \* \* \*

*Instructions*

\* \* \* \* \*

*Annual Expenses*

\* \* \* \* \*

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)).

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

$$AFFE = \frac{[(F_1/365) * AI_1 * D_1] + [(F_2/365) * AI_2 * D_2] + [(F_3/365) * AI_3 * D_3] + \text{Transaction Fees}}{\text{Average Net Assets of the Fund}}$$

Where:

AFFE = Acquired Fund fee expense;

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

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 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) If the Acquired Fund and the Registrant are part of the same "group of investment companies" (as defined in section 12(d)(1)(G)(ii) of the 1940 Act (15 U.S.C. 80a-12(d)(1)(G)(ii))), the total annual expense ratio used for purposes of this calculation (F<sub>1</sub>) is the actual total annual expense ratio of the Acquired Fund for the Acquiring Fund's most recent fiscal year. If the Acquired Fund and the Registrant are not part of the same "group of investment companies," the total annual expense ratio used for purposes of this calculation (F<sub>1</sub>) is: (i) the total annual fund operating expense ratio for the Acquired Fund's most recent fiscal year disclosed in the financial highlights table of the Acquired Fund's most recent semi-annual report filed with the Commission; or (ii) in the case of an Acquired Fund that does not provide a total annual expense ratio in its semi-annual report or does not file a semi-annual report with the Commission, the ratio of total annual operating expenses of the Acquired Fund to average total annual net assets of the Acquired Fund for its most recent fiscal year, as disclosed in the most recent

communication from the Acquired Fund to the Registrant.

(e) 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 as of each month end 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 funds in which the New Registrant assumes it will 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 substitute the term used in the prospectus to refer to the Acquired Funds for the bracketed portion of the caption provided.

8. Item 3 of Form N-4 (referenced in §§ 239.17b and 274.11c) is amended by adding a sentence at the end of paragraph 17(a) under the Instructions 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*

\* \* \* \* \*

*Total Annual [Portfolio Company] Operating Expenses*

\* \* \* \* \*

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 of the Acquiring Funds, calculated in accordance with instruction 3(f) of 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. Item 3 of Form N-6 (referenced in §§ 239.17c and 274.11d) is amended by adding a sentence at the end of paragraph 4(b) under the Instructions 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 of the Acquiring Funds, calculated in accordance with instruction 3(f) of Item 3 of Form N-1A (17 CFR 239.15A; 17 CFR 274.11A). For purposes of this section, 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)).

\* \* \* \* \*

Dated: October 1, 2003.

By the Commission.

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 03-25336 Filed 10-7-03; 8:45 am]

**BILLING CODE 8010-01-P**