The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
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SEC Adopts New Rules and Disclosure Requirements Relating to Fund of Funds Investments

 [20135] June 28, 2006 TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 27-06 SEC RULES MEMBERS No. 58-06 VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 5-06 UNIT INVESTMENT TRUST MEMBERS No. 19-06 SMALL FUNDS MEMBERS No. 47-06 RE: SEC ADOPTS NEW RULES AND DISCLOSURE REQUIREMENTS RELATING TO FUND OF FUNDS INVESTMENTS The SEC has approved three new rules under the Investment Company Act of 1940 ("Act") that broaden the ability of an investment company to invest in shares of another investment company under "fund of funds" arrangements.1 The new rules codify and expand upon a number of exemptive orders the SEC has issued that permit funds to invest in other funds. The SEC also has adopted amendments to several forms used by investment companies to increase the transparency of the expenses of funds of funds. The effective date of the new rules is July 31, 2006. All new registration statements on Forms N-1A, N-2, N-3, N-4, or N-6, and all post-effective amendments that are annual updates to effective registration statements on these forms filed on or after January 2, 2007, must include the disclosure required by the amendments. The most significant aspects of the new rules and disclosure requirements are summarized below. I. Rule 12d1-1 - Investments in Money Market Funds Rule 12d1-1 codifies SEC exemptive orders to permit funds to enter into "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. The rule provides exemptions from Sections 12(d)(1) and 17(a) of the Act, as well as Rule 17d-1, to permit funds to invest in affiliated money market funds. In 1 SEC Release Nos. 33-8713 and IC-27399 (June 20, 2006), 71 FR 36640 (June 27, 2006). The final rules can be found on the SEC's website at http://www.sec.gov/rules/final/2006/33-8713.pdf. 2 addition, the rule expands upon exemptive orders to permit funds to invest cash in unaffiliated money market funds and codifies exemptive orders to permit funds to invest in unregistered money market funds. The rule's exemption will be available only for investments in an unregistered money market fund that operates like a money market fund registered under the Act.2 The rule also is available to closed-end funds and business development companies, as well as unregistered funds, to permit them to invest available cash in a money market fund. The rule will eliminate most of the conditions included in exemptive orders provided for cash sweep arrangements. It retains, however, a condition precluding the acquiring fund from paying a sales load, distribution fee, or service fee on acquired fund shares, or if it does, requiring the acquiring fund's investment adviser to waive a sufficient amount of its

advisory fee to offset the cost of the load or distribution fees. II. Rule 12d1-2 – Affiliated Funds of Funds Section 12(d)(1)(G) of the Act 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. Rule 12d1-2 provides relief from Section 12(d)(1)(G) limitations on investments an affiliated fund of funds can make. In particular, Rule 12d1-2 codifies, and in some cases expands, relief provided to affiliated funds of funds relating to investments in unaffiliated funds, investments in other types of issuers, and investments in money market funds. Specifically, Rule 12d1-2 permits an affiliated fund of funds to acquire up to three percent of the securities of funds that are not part of the same group of investment companies, subject to the limits in Sections 12(d)(1)(A) or 12(d)(1)(F) of the Act.3 The rule also permits an affiliated fund of funds to 2 Specifically, an unregistered money market fund is required to (i) limit its investments to those in which a money market fund may invest under Rule 2a-7 under the Act, and (ii) undertake to comply with all the other provisions of Rule 2a-7. In addition, the unregistered money market fund's adviser must be registered as an investment adviser with the SEC. Finally, the acquiring fund is required to "reasonably believe" that the unregistered money market fund operates like a registered money market fund and that it complies with certain provisions of the Act. A fund would reasonably believe that an acquired fund was in compliance with these provisions if, for example, it received a representation from the acquired fund (or the adviser to the acquired fund) that the fund would comply with the relevant provisions in all material respects and if the acquiring fund had no reason to believe that the acquired fund was not, in fact, complying with the relevant provisions in all material respects. 3 A fund relying on Section 12(d)(1)(A) (together with any companies or funds it controls) may not acquire more than 3 percent of the outstanding voting securities of any other fund in a different fund group. In addition, the acquiring fund will 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. A fund relying on Section 12(d)(1)(F) (together with its affiliates) may not acquire more than 3 percent of the outstanding stock of any other fund in a different fund group. The acquiring fund also will 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. In addition, the acquiring fund will be limited to charging a sales load of 1½ percent on its shares and will be prevented from redeeming more than 1 percent of the shares of any acquired fund during any period of less than 30 days. 3 invest directly in stocks, bonds, and other types of securities (i.e., securities not issued by a fund) if such investments are consistent with the fund's investment policies. Finally, Rule 12d1-2 permits an affiliated fund of funds to invest in affiliated or unaffiliated money market funds in reliance on Rule 12d1-1. Therefore, any fund that invests in a money market fund in reliance on Rule 12d1-2 must comply with the conditions in Rule 12d1-1. III. Rule 12d1-3 – Unaffiliated Funds of Funds Rule 12d1-3 codifies SEC exemptive orders to permit funds relying on Section 12(d)(1)(F) of the Act4 to charge a sales load greater than 1½ percent, provided the aggregate sales loads any investor pays (i.e., the combined distribution expenses of both the acquiring and acquired funds) does not exceed the limits on sales loads established by the NASD for funds of funds. This exemption also is available to an affiliated fund of funds relying on Rule 12d1-2 to invest in funds in a different fund group. IV. Amendments to Investment Company Act Forms The SEC has adopted amendments to Forms N-1A, N-2, N-3, N-4, and N-6 to require that investors in a registered fund of funds receive increased disclosure of the costs of investing in these arrangements. Under amendments to Form N-1A, any registered open-end fund investing in shares of another

fund will be required to include in its prospectus fee table an additional line item titled “Acquired Fund Fees and Expenses” under the section that discloses total annual fund operating expenses. The line item will set forth the acquiring fund’s pro rata portion of the cumulative expenses charged by funds in which the acquiring fund invests. Those costs will be included in the acquiring funds’ total annual fund operating expenses, which will be reflected in the “Example” portion of the fee table.5 The SEC also is adopting instructions to assist an acquiring fund in determining the amount of acquired funds’ fees and expenses that must be reflected in its fee table. The instructions require the acquiring fund to aggregate the amount of total annual fund operating expenses of acquired funds (which are indirectly paid by the acquiring fund) and transaction fees (which are directly paid by the acquiring fund over the past year) and express the total amount as a percentage of average net assets of the acquiring fund. Under this approach, the acquiring fund must determine the average invested balance and number of actual days invested in each acquired fund. The acquiring fund also will be 4 Section 12(d)(1)(F) of the Act provides an exemption from Section 12(d)(1) that allows a registered fund to invest all its assets in other registered funds if: (i) the acquiring fund (together with its affiliates) acquires no more than 3 percent of the outstanding stock of any acquired fund; and (ii) the sales load charged on the acquiring fund’s shares is no greater than 1½ percent. 5 In response to comments on the proposal, a fund will be permitted to omit the new separate line item if the aggregate expenses attributable to acquired funds do not exceed 0.01 percent (one basis point) of average net assets of the acquiring fund. The instructions to the amended fee table instead allow these expenses to be included in “Other Expenses.” 4 required to include in the expense calculation any transaction fee the acquiring fund paid to acquire or dispose of shares of a fund during the past fiscal year (even if it no longer holds shares of that fund).6 The amendments to Form N-2 require a registered closed-end fund of funds (including a closed-end fund of hedge funds) to include its pro rata portion of the cumulative expenses charged by the acquired funds, including management fees and expenses, transaction fees and performance fees, including incentive allocations (fees based on a share of income, capital gains and/or appreciation), as a line item in its fee table. Each acquiring closed-end fund must determine expenses attributable to its investments in acquired funds during the most recent fiscal year together with, if applicable, any investments it intends to make with the proceeds of its present offering. The instructions require a fund to reflect the amount of expenses attributed to the intended investments assuming those investments had been held by the acquiring fund during its most recent fiscal year. The amendments to Form N-3 require the same disclosure as required in amended Forms N- 1A and N-2 for separate accounts organized as management investment companies that offer variable annuity contracts. The amended instructions for Forms N-4 and N-6 are different from the instructions in Forms N-1A, N-2, and N-3, however, because Forms N-4 and N-6 already require registrants (i.e., separate accounts organized as UITs that offer variable annuity and variable life contracts) to disclose expenses of funds (“portfolio companies”) in which the separate account invests. Accordingly, amended Forms N-4 and N-6 require that if a portfolio company invests in other funds, the separate account must include in the item disclosing the portfolio company’s “other expenses,” the acquired funds’ fees and expenses calculated according to the instructions to Form N-1A. Ari Burstein Associate Counsel 6 The new disclosure requirements also will apply with respect to investments in any unregistered fund that would be an investment company under Section 3(a) of the Act but for the exceptions provided in Sections 3(c)(1) and 3(c)(7) of the Act.