

COMMENT LETTER

December 3, 2003

Comment Letter on Changes to Fund of Fund Investment Rules (pdf)

December 3, 2003 Mr. Jonathan G. Katz Secretary U.S. Securities and Exchange Commission 450 Fifth Street, N.W. Washington, D.C. 20549 Re: Fund of Funds Investments (File No. S7-18-03) Dear Mr. Katz: The Investment Company Institute¹ is pleased to provide comments on the Securities and Exchange Commission's proposals to broaden the ability of an investment company to invest in shares of another investment company under "fund of funds" arrangements.² In particular, the Commission has proposed new Rules 12d1-1, 12d1-2 and 12d1-3 under the Investment Company Act of 1940 as well as amendments to several forms used by investment companies. The Institute strongly supports the Commission's proposals. The proposed rules would codify and expand upon a number of exemptive orders that the Commission has issued that permit funds to invest in other funds beyond the limitations contained in Section 12(d)(1) of the Act. As noted in the Proposing Release, the situations codified in the proposed rules do not raise the concerns that Section 12(d)(1) was designed to address. In addition, the proposed rules would benefit funds and their shareholders by providing funds with additional flexibility to enter into fund of funds arrangements and by eliminating the cost and time involved in obtaining an exemptive order. Finally, the proposals would relieve the burden on Commission staff in processing exemptive applications. Our comments are primarily technical in nature. In particular, we recommend that certain changes be made to proposed Rule 12d1-2 to add greater flexibility for funds that enter 1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,672 open-end investment companies ("mutual funds"), 605 closed-end investment companies, 108 exchange-traded funds and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about \$7.149 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households. 2 Investment Company Act Release No. 26198 (October 1, 2003), 68 FR 58226 (October 8, 2003) ("Proposing Release"). Mr. Jonathan G. Katz December 3, 2003 Page 2 into fund of funds arrangements (e.g., by allowing in-kind transfer of securities) and that the Commission provide relief for funds that enter into cash management arrangements other than investments in money market funds under proposed Rule 12d1-1 (e.g., relief from Rule 17d-1 of the Act when entering into joint repurchase agreements). In addition, we recommend that a de minimis exemption be added to the proposed disclosure requirements. Finally, we have certain technical recommendations to several definitions contained in the proposals as well as the calculations required under the proposed disclosure requirements. Our specific comments follow. I. Proposed Rules A. Proposed Rule 12d1-1 Proposed 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.³ The Institute strongly supports the proposed rule. The Institute, in an earlier submission to SEC staff relating to affiliated transactions,⁴ recommended that the Commission adopt a rule that would enable funds to use an affiliated money market fund as a cash management device for uninvested cash, similar to the relief that would be granted by proposed Rule 12d1-1. As we noted in our earlier submission, there are numerous benefits to permitting these arrangements, such as providing an alternative to direct investment of cash balances in money market instruments and reducing transaction costs. We have one technical comment on proposed Rule 12d1-1. Under a condition of the proposed rule, an acquiring fund would not be permitted to pay any “administrative fees” on acquired 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 administrative fees.⁵ We note that the term “administrative fees” is currently used in several other rules and forms used by investment companies⁶ with different meanings and we are concerned the inconsistent application of this term could cause confusion. To address this concern, the Institute recommends that the Commission eliminate the defined term “administrative fees” from the proposed rule and instead insert the proposed definition itself into the rule provision. At the very least, we recommend that the Commission use a term other than “administrative fees” to describe the fees referred to in this provision. ³ Specifically, the proposed rule would codify exemptive orders to permit investments in affiliated money market funds, expand upon exemptive orders to permit investments in unaffiliated money market funds, and codify exemptive orders that permit funds to invest in money market funds that are not registered investment companies. ⁴ Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission, dated December 10, 1998 (enclosing Recommendations for New and Amended Rules Concerning Affiliated Transactions). ⁵ The proposed rule defines “administrative fees” 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.” Proposed Rule 12d1-1(c)(1). ⁶ See, e.g., Investment Company Act Rule 11a-3 and Instruction 3 to Item 3 of Form N-1A. Mr. Jonathan G. Katz December 3, 2003 Page 3 While we strongly support proposed Rule 12d1-1, we believe that there are other cash management tools that could be utilized by funds to obtain the same benefits as those that would be provided under the proposed rule, e.g., joint repurchase agreements. The Institute, in a submission to the SEC staff recommending proposals to improve investment company regulation,⁷ recommended that the Commission amend Rule 17d-1 under the Act to permit joint transactions by a fund and its affiliates where the fund participates on terms not different from those applicable to any affiliated participant. We believe these transactions do not present the risks that Section 17(d) was designed to prevent and recommend that, in order to provide funds with greater flexibility relating to cash management, the Commission should consider amendments to Rule 17d-1 to permit such joint transactions.⁸ B. Proposed Rule 12d1-2 Proposed Rule 12d1-2 would codify, and in some cases expand upon, relief provided to affiliated funds of funds from the limitations contained in Section 12(d)(1)(G) of the Act.⁹ The Institute strongly supports the proposed rule, as it would provide greater flexibility to funds to meet their investment objectives. In order to increase this flexibility, we recommend that proposed Rule 12d1-2 be revised to permit acquiring funds to obtain shares of an acquired fund using an in-kind transfer and exempt such transactions from the “for cash” requirement of Rule 17a-7 under the Act. Currently, in order for a purchase or sale transaction between an investment company and certain affiliated persons to be exempt under Rule 17a-7, the transaction must be “for no consideration other than cash payment

against prompt delivery of a security.” We believe that it would be more efficient for a fund, and would avoid having a fund bear unnecessary expenses, if a fund could transfer securities that it holds directly to the affiliated fund in return for fund shares.¹⁰ Such a revision would be consistent with previous relief granted by the Commission relating to in-kind transfers under Rule 17a-7.¹¹ 7 Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission, dated May 1, 2002 (enclosing Proposals to Improve Investment Company Regulation). 8 We note that the staff also made such a recommendation in its 1992 study on investment company regulation. See Protecting Investors: A Half Century of Investment Company Regulation, Division of Investment Management, U.S. Securities and Exchange Commission (May 1992). 9 Specifically, proposed Rule 12d1-2 would provide relief to affiliated funds of funds relating to investments in unaffiliated funds, investments in other types of issuers, and investments in money market funds. We have one technical comment on proposed Rule 12d1-2. In order to clarify the scope of the proposed rule, we suggest that the Commission add the words “other than securities issued by another registered investment company that is in the same group of investment companies” after “Securities issued by an investment company,” in proposed Rule 12d1- 2(a)(1). Otherwise, proposed Rule 12d1-2(a)(1) could be read to subject investments in registered investment companies in the same group of investment companies as the acquiring fund to the limits in Section 12(d)(1)(A) or 12(d)(1)(F) of the Act, which we do not believe is intended. 10 For example, a general equity fund that holds foreign securities in its portfolio may wish to obtain exposure to the international market by investing in an affiliated international fund. Rule 17a-7’s “for cash” requirement would compel the fund to sell its foreign securities and then use the cash to purchase shares of the fund. 11 See, e.g., The DFA Investment Trust Company (pub. avail. October 17, 1995); Frank Russell Investment Company, Investment Company Act Release Nos. 25416 (February 12, 2002) (Notice) and 25458 (March 12, 2002) (Order); First Mr. Jonathan G. Katz December 3, 2003 Page 4 II. Proposed Disclosure Requirements The proposal would require funds of funds to provide increased disclosure to investors of the costs of investing in such arrangements. In particular, a fund that invests in other funds would be required 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 proposal includes instructions on calculating the fees and operating costs of the acquired funds. The Institute supports the proposed disclosure to investors. We believe, however, that there should be a de minimis exemption from the proposed disclosure requirements. In particular, we recommend that a fund not be required to provide the additional line item in the fee table if the aggregate fees and costs of acquired funds do not exceed a specified minimum level (e.g., one basis point).¹² Instead, we recommend that such a fund be required to include these de minimis fees and costs in the “Other Expenses” section of the fee table. We believe that the disclosure of de minimis costs in a separate line item would be immaterial to investors. In addition, by including these fees and expenses in the “Other Expenses” section, the Commission can ensure that they will still be included in fund’s total operating expenses.¹³ The Institute also has several technical comments on the proposed disclosure requirements.¹⁴ In particular, proposed Instruction 3(f)(ii) to Item 3 of Form N-1A describes the calculation that would be used to determine the acquired fund’s “Fees and Expenses.” This formula includes both operating expenses of the acquired funds (i.e., based on the acquired funds’ expense ratios) and any “transaction fees” paid in connection with acquiring the acquired funds during the most recent fiscal year. This formula does not correspond, however, to the expense ratio calculations currently required in Item 9 of Form N-1A (“Financial Highlights Information”), which does not consider acquired funds’ operating expenses or related transaction fees. The annual fund operating expenses found in Item 3 would therefore generally be higher than those in Item 9. In order to avoid

confusion in the disclosure of fund expenses, we recommend, at the very least, that funds be provided the latitude to address this situation in a footnote to the fee table. American Investment Funds, Investment Company Act Release Nos. 22795 (August 22, 1997) (Notice) and 22826 (September 18, 1997) (Order). 12 For example, assume a fund (with average net assets of \$100 million) invests its cash (which represents three percent of its assets) for 365 days in an affiliated money market fund, whose total annual fund operating expense ratio is 30 basis points. Under the proposed calculation of an acquired fund's fees and expenses, a fund would be required to include a separate line item in its fee table disclosing to investors that the "acquired fund fee expense" totals 9/10 of a basis point. 13 Including the de minimis fees and expenses in the "Other Expenses" section of the fee table is consistent with the treatment of expenses of registered investment companies under Regulation S-X. In particular, §210.6-07 describes fund expenses that must be stated as a separate line item in the fund's income statement. Under this section, expense types that amount to less than a specified level need not be broken out separately, and are typically aggregated and combined as other expenses. 14 Although we reference Form N-1A when discussing our technical comments, our comments also apply to the other forms amended by the proposed disclosure requirements. Mr. Jonathan G. Katz December 3, 2003 Page 5 Similarly, proposed Instruction 3(f)(iv) to Item 3 of Form N-1A indicates that if the acquired fund is part of the same group of investment companies as the acquiring fund and its year end does not coincide with the acquiring fund's year end, the acquiring fund would be required to calculate a special purpose expense ratio covering the acquired fund's fiscal year. The Institute questions whether it is necessary for funds to calculate this special purpose expense ratio, as expense ratios typically do not fluctuate very much from year to year. We therefore recommend that an acquiring fund be able to use the acquired fund's gross total annual expense ratio for its most recent fiscal year end disclosed in the financial highlights table in its most recent semi-annual report filed with the Commission.15 Finally, proposed Instruction 3(f)(v) to Item 3 of Form N-1A would require the acquiring fund to calculate an "average invested balance" based on month-end balances. We recommend that funds be permitted to calculate the "average invested balance" based on the value of the investment "measured no less frequently than monthly." This would provide funds the flexibility to calculate the average invested balance based on either monthly or daily balances. We note that Instruction 4(a) to Item 9(a) of Form N-1A permits average net assets to be calculated in this manner for purposes of the ratios to be included in the financial highlights table. * * * * * The Institute appreciates the opportunity to provide comments on this proposal. If you have any questions regarding our comments, or would like any additional information, please contact me at (202) 326-5824 or Ari Burstein at (202) 371-5408. Sincerely, Amy B.R. Lancellotta Senior Counsel cc: Paul F. Roye, Director Robert E. Plaze, Associate Director C. Hunter Jones, Assistant Director Penelope W. Saltzman, Senior Counsel Division of Investment Management 15 If, however, the acquired fund's expense ratio has changed materially since its most recent fiscal year end, we recommend that the acquiring fund use an updated expense ratio.

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