SEC Issues Final “Fund of Funds” Rules
From the Investment Management Practice Group

I Introduction

On June 20, 2006, the Securities and Exchange Commission (“SEC”) adopted three new rules under the Investment Company Act of 1940 (the “Act”) addressing “fund of funds” arrangements. New Rules 12d1-1, 12d1-2 and 12d1-3 (the “Fund of Funds Rules”), address unaffiliated fund of funds arrangements as well as affiliated fund of funds arrangements. Over the years, the SEC has issued several types of orders granting exemptive relief in these areas under certain conditions. These new rules essentially codify these exemptive orders. In addition, the SEC adopted changes to the prospectus disclosure forms for open-end and closed-end funds of funds to require that the expenses of acquired funds (in aggregate form) be shown as a separate line item in the prospectus fee table of the acquiring fund.

The “cash sweep” fund of funds rule, Rule 12d1-1, also provides certain necessary exemptions from Section 17(a) and Rule 17d-1 and 17e-1 of the Act in order to enable Rule 12d1-1 to be fully implemented. This memorandum provides a summary of the Fund of Funds Rules, which become effective on July 31, 2006.

II Compliance Date

Funds that file new registration statements on Forms N-1A, N-2, N-3, N-4, and N-6, or post-effective amendments that are annual updates to effective registration statements on or after January 2, 2007, must include the new “fund of funds” disclosure required by the amendments. Otherwise, the Fund of Funds Rules are effective on July 31, 2006 and funds may rely on them as of that date.

III The Final Rules

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

Rule 12d1-1 permits funds to invest in shares of affiliated and unaffiliated registered and unregistered money market funds in excess of the limits set forth in Section 12(d)(1). Rule 12d1-1 is designed to permit “cash sweep” arrangements in which a fund invests all or a portion of its available cash in a money market fund rather than investing directly in short-term instruments. An important element of the rule, however, is that the underlying money market fund must be Rule 2a-7 compliant.

Under Rule 12d1-1, the Acquiring Fund may not pay any administrative fee (which is defined to include sales charges, 12b-1 fees and/or services fees) charged in connection with the purchase, sale or exchange of a money market fund or the Acquiring Fund’s investment adviser must waive a portion of its advisory fee in an amount necessary to offset any administration fee.

In addition to investing in a registered money market fund used as a “cash sweep” vehicle, Rule 12d1-1 permits an Acquiring Fund to invest in unregistered money market funds, provided that the adviser of the Acquired Fund is registered with the SEC under the Investment Advisers Act of 1940, as amended, and various other conditions are met. Under these conditions, the Acquiring Fund must reasonably believe that the unregistered money market fund satisfies the following conditions as if it were a registered open-end investment company: (i) it operates in compliance with Rule 2a-7 under the Act, (ii) it complies with Sections 17(a), (d), (e), 18 and 22(e) of the Act, (iii) it has adopted procedures reasonably designed to ensure compliance with Sections 17(a), (d), (e), 18 and 22(e) of the Act, and (iv) it satisfies certain recordkeeping require-
ments. In addition, in order for an Acquiring Fund to invest in reliance on Rule 12d1-1 in an unregistered money market fund that does not have a board of directors, the Acquired Fund’s investment adviser must perform the duties required of a money market fund’s board of directors under Rule 2a-7. This rule is also available to closed-end funds, business development companies, and unregistered funds (e.g., a hedge fund would be allowed to sweep its cash into a registered money market fund pending investment or distribution of the cash to investors).

While Rule 12d1-1 does not, by its terms, limit the level of advisory fee the Acquiring Fund may charge, or require the Acquiring Fund’s board to make special findings that investors are not paying duplicate advisory fees, the SEC has stated that, in its view, to the extent advisory services are being performed by another person, an Acquiring Fund’s adviser would have a fiduciary duty to reduce its fee by the amount that represents compensation for services performed by another person.

Rule 12d1-1 also provides exemptions from Section 17(a) and Rule 17d-1 (and Section 57, for business development companies), which restrict a fund’s ability to enter into transactions and joint arrangements with affiliates. These restrictions would otherwise prohibit an Acquiring Fund from investing in a money market fund in the same fund complex or prohibit a fund that acquires 5% or more of the securities of a money market fund from making additional investments in the money market fund. In addition, the rule provides a carve out from the requirements of Rule 17c-1 to permit an Acquiring Fund to pay commissions, fees or other remuneration to an affiliated broker-dealer without need to comply with the quarterly board review and recordkeeping requirements of Rule 17c-1(b)(3) and 17c-1(d)(2).

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

Section 12(d)(1)(G) permits a registered open-end fund to acquire an unlimited amount of shares of registered open-end funds and unit investment trusts that are parts of the same “group of investment companies” as the Acquiring Fund, provided among other things that the Acquiring Fund hold only shares of the Acquired Funds, government securities, and short-term paper. Rule 12d1-2 permits a fund relying on Section 12(d)(1)(G) to invest in a broader set of investments:

- Investments in unaffiliated funds - Under Rule 12d1-2, an Acquiring Fund relying on Section 12(d)(1)(G) may acquire securities of investment companies that are not part of the same group of investment companies as the Acquiring Fund, subject to the limits in Section 12(d)(1)(A) or 12(d)(1)(F) with respect to such unaffiliated Acquired Funds;
- Investment in other types of issuers - Rule 12d1-2 permits an Acquiring Fund in an affiliated fund of funds arrangement to invest directly in stocks, bonds, and other types of securities;
- Investments in money market funds - Rule 12d1-2 permits an Acquiring Fund in an affiliated fund of funds arrangement to invest in affiliated or unaffiliated money market funds in reliance on Rule 12d1-1.

One significant consequence of Rule 12d1-2 is the flexibility it affords for an equity or bond fund to invest any portion of its assets in an affiliated fund, so long as the acquisition is consistent with the investment policies of the investing fund and the restrictions of the Rule. For instance, an equity or bond fund that normally invests directly in securities (that is, a fund that is not a “fund of funds”) may gain exposure to a different asset class (such as foreign securities or small cap securities) by investing in an affiliated fund focused on this investing class. In this circumstance, the investing fund is not constrained by the 3, 5 and 10 percent share ownership limits of Rule 12(d)(1)(A) or the 3 percent share ownership and ½ percent sales load limits of Rule 12(d)(1)(F) because these restrictions apply only to a fund’s investment in an unaffiliated fund made in reliance on Rule 12d1-2.

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

Section 12(d)(1)(F) of the Act provides an exemption from Section 12(d)(1) that permits a registered fund to invest all of 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 Acquired Fund’s shares is no greater than 1½ percent. Rule 12d1-3 allows funds relying on Section 12(d)(1)(F) to charge sales loads greater than 1½ percent provided that the aggregate sales load any investor pays (i.e., the combined distribution expenses of both the Acquiring and Acquired Funds) does not exceed the limits on sales loads established by the NASD for funds of funds.

D. Amendments to Disclosure Forms; Transparency of Fund of Funds Expenses

The SEC also adopted amendments to Form N-1A and Form N-2 (for open-end and closed-end funds, respectively) requiring an Acquiring Fund to disclose in its prospectus fee table the expenses of all Acquired Funds in an additional line item, “Acquired Fund Fees and Expenses,” under the section that discloses total annual operating expenses. This disclosure is designed to provide investors with a better understanding of the actual costs of investing in a fund of funds.

The Adopting Release also provides specific instructions designed to assist an Acquiring Fund in determining the amount of the Acquired Funds’ fees and expenses to be included in the Acquiring Fund’s fee table. The Acquiring
Fund must aggregate the amount of total annual fund operating expenses of the Acquired Funds and transaction fees over the past year and express the total amount as a percentage of average net assets of the Acquiring Fund.

The new disclosure requirements also 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. As a result, funds with cash sweep arrangements into unregistered funds will also be required to report the expenses of the unregistered money market fund which serves as the Acquiring Fund’s sweep vehicle.

NOTES


2 Section 12(d)(1)(A) of the Act generally provides that it is unlawful for any registered investment company (and companies or funds it controls) (“Acquiring Fund”) to acquire the securities of any other investment company (registered or not) (“Acquired Fund”), and for any unregistered investment company (and companies or funds it controls) (“Acquiring Fund”) to acquire the securities of any registered investment company (“Acquired Fund”) in excess of the following limits: (i) no more than 5% of the Acquiring Fund’s total assets may consist of securities of the Acquired Fund, and (ii) no more than 10% of the Acquiring Fund’s total assets may consist of securities of the Acquired Fund and all other investment companies.

3 See 17 CFR 270.2a-2.

4 These include requirements to maintain and preserve certain records required by section 31a-1(b)(1), 31a-1(b)(2)(i), 31a-1(b)(2)(iv) and 31a-1(b)(9) of the Act and to retain permanently, the first two years in an easily accessible place, records required by (ii) and (iv) above.

5 An Acquiring Fund could reasonably believe that an Acquired Fund was in compliance with these provisions if, for example, it received an appropriate representation from the Acquired Fund 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.

6 See footnote 52 of the Adopting Release.

7 As we noted in note 2 above, Section 12(d)(1)(A) generally imposes limits on the extent to which one fund may invest in another. A fund relying on Section 12(d)(1)(F) could not acquire more than 3 percent of the outstanding stock of any other fund in a different fund group. The Acquiring Fund also would be required to either seek instructions from its shareholders as to how to vote the shares of the Acquired Fund, or to vote the shares in the same proportion as the vote of all other shareholders of the Acquired Fund. See 15 U.S.C. 80a-12(d)(1)(F) (referencing 15 U.S.C. 80a-12(d)(1)(E)). In addition, the Acquiring Fund would be limited to charging a sales load of 1½ percent on its shares and could be prevented from redeeming more than 1 percent of the shares of any Acquired Fund during any period of less than 30 days.

8 Any fund relying on the exemption provided in Rule 12d1-3 must comply with the limitations set forth in NASD Sales Charge Rule 2830(d)(3), regardless of whether sales of the fund’s shares by broker-dealers are otherwise subject to the rule according to its terms.

9 The item will appear directly above the line item entitled “Total Annual Fund Operating Expenses.”