

SEC Adopts New Fund of Funds Rules

On June 20, 2006, the Securities and Exchange Commission (the “SEC”) adopted new rules under the Investment Company Act of 1940 (the “Act”) relating to funds that invest in shares of other funds.¹ The three new rules, which took effect on July 31, 2006, codify and expand exemptive relief that has previously been provided by the SEC. The SEC is also imposing new disclosure requirements relating to the expenses that registered funds incur by investing in other registered and unregistered funds. Notably, the new disclosure requirements apply even to funds that will not rely on any of the new rules. The SEC estimates that half of all registered funds will be affected by the new disclosure requirements.

The new rules address the following principal areas: (1) investments by registered and unregistered funds in money market funds; (2) investments by registered “funds of funds” relying on Section 12(d)(1)(G) of the Act, in funds that are not part of the same group of investment companies as the acquiring funds and in other securities; and (3) permissible sales loads for registered funds relying on Section 12(d)(1)(F) of the Act.

The SEC also amended Forms N-1A, N-2, N-3, N-4 and N-6 to require greater disclosure with respect to annual operating expenses in the fee tables for registered funds that invest all or part of their assets in other funds (including unregistered funds), which will apply to all new registration statements and all post-effective amendments that are annual updates to effective registration statements filed on or after January 2, 2007.

I. New Rule 12d1-1: Exemptions for Investments in Money Market Funds

Sections 12(d)(1)(A) and 12(d)(1)(B) of the Act limit registered funds’ investments in other registered funds and registered open-end funds’ sale of shares to other registered funds. Section 12(d)(1)(A) also limits investments in registered funds by unregistered funds that are generally excluded from the definition of “investment company” by Sections 3(c)(1) or 3(c)(7) of the Act (“3(c)(1)/3(c)(7) Funds”). New Rule 12d1-1 permits registered funds and 3(c)(1)/3(c)(7) Funds to invest in affiliated and unaffiliated money market funds (including certain unregistered funds), consistent with such investing funds’ investment objectives and policies, without regard to the Section 12(d)(1)(A) and (B) limitations or the affiliated transaction prohibitions of Section 17(a).

An acquiring fund relying on Rule 12d1-1 is subject to the following conditions:

- An acquiring fund may not pay a sales charge (as defined in rule 2830(b)(8) of the Conduct Rules of the NASD) or a service fee (as defined in rule 2830(b)(9)) on acquired fund shares, or, if such charges or fees are paid, the acquiring fund’s investment adviser must waive its advisory fee in an amount sufficient to offset them.
- An acquiring fund may invest in an unregistered money market fund only if (i) the acquiring fund reasonably believes that the unregistered money market fund complies with Rule 2a-7 and Sections 17(a), (d), (e), 18 and 22(e) of the Act and (ii) the investment adviser of the unregistered money market fund is registered with the SEC as an investment adviser under the Investment Advisers Act of 1940.

Unlike many prior exemptive orders issued by the SEC, Rule 12d1-1 does not limit advisory fees payable by an acquiring fund or require a fund board to make special findings. However, the SEC in its Adopting Release states that the fiduciary

¹ See Rel. No. IC-27399 (the “Adopting Release”).

duties of a fund's board obligate the board to prevent the fund from being overcharged for services provided. As a practical matter, therefore, boards will need to scrutinize the overall fees paid in respect of such investments.

Rule 12d1-1 also provides an exemption from Rule 17e-1 in the event a broker becomes an affiliated person of an acquiring fund because the broker and the acquiring fund are affiliated persons of the same money market fund and the acquiring fund is an affiliated person of the money market fund solely because it owns 5% or more of the money market fund's outstanding securities. Pursuant to this exemption, an acquiring fund may pay commissions or other fees to such broker without complying with the quarterly board review and recordkeeping requirements set forth in Rule 17e-1.

II. New Rule 12d1-2: Exemptions for Investment Companies Relying on Section 12(d)(1)(G) of the Act

Section 12(d)(1)(G) of the Act permits a registered open-end fund or unit investment trust to acquire an unlimited number of shares of other registered open-end funds and registered unit investment trusts so long as they are part of the same group of investment companies as the acquiring fund and certain other conditions are met. Prior to Rule 12d1-2, a registered fund that relied on Section 12(d)(1)(G) could, absent an exemptive order, only invest in (a) funds that are part of the same group of investment companies as the acquiring fund, (b) government securities and (c) short-term paper. Now, under Rule 12d1-2, a fund may rely on Section 12(d)(1)(G) and also (i) acquire securities of funds that are not part of the same group of investment companies as the fund, subject to the limitations set forth in Sections 12(d)(1)(A) or 12(d)(1)(F),² (ii) invest directly in securities not issued by a fund, assuming such investments are consistent with the acquiring fund's investment policies, and (iii) acquire securities of affiliated and unaffiliated money market funds in accordance with Rule 12d1-1. In addition, as a consequence of Rule 12d1-2, a fund may invest in an acquired fund that in turn invests in money market funds under Rule 12d1-1.

III. New Rule 12d1-3: Exemptions for Investment Companies Relying on Section 12(d)(1)(F) of the Act

Section 12(d)(1)(F) of the Act permits a registered fund to invest its assets in securities issued by other funds so long as the acquiring fund (together with its affiliates) does not acquire more than 3% of any acquired fund's outstanding securities or charge a sales load greater than 1½% and complies with certain restrictions relating to the redemption and voting of such acquired fund shares. Under Rule 12d1-3, a registered fund may still rely on Section 12(d)(1)(F) and charge a sales load greater than 1½% provided that the aggregate sales load of the registered fund does not exceed the limits established by the NASD for funds of funds.³

IV. Amendments to Disclosure Forms

The SEC has adopted amendments to Forms N-1A, N-2, N-3, N-4 and N-6 to require funds to disclose in their prospectuses the expenses of the funds in which they invest. Registered open-end and closed-end funds filing on Forms N-1A, N-2 and N-3 are required to add an additional line item titled "Acquired Fund Fees and Expenses" to their fee tables which sets forth a fund's pro rata portion of the expenses charged by the acquired funds. If the fees and expenses that a fund incurs indirectly as a result of investing in other funds do not exceed one basis point, then those expenses need not be stated as a separate line item, but in that case they must be included as part of the fund's "Other Expenses." With respect to funds registered on Forms N-4 and N-6, "Total Annual Operating Expenses" for a fund must include fees and expenses incurred indirectly by the fund as a result of investment in shares of an acquired fund. The SEC has

² Note that for purposes of calculating the amount of acquired fund securities held by an acquiring fund, Section 12(d)(1)(A) requires the acquiring fund to aggregate the securities held by the acquiring fund and any company or companies controlled by such acquiring fund whereas Section 12(d)(1)(F) requires the acquiring fund to aggregate the securities held by the acquiring fund and such acquiring fund's affiliated persons.

³ See NASD Rule 2830(d)(3).

also provided detailed instructions for how to calculate the amount of an acquired fund's fees and expenses that must be disclosed. Significantly, the disclosure requirements encompass the fees and expenses resulting from investments in 3(c)(1)/3(c)(7) Funds, as well as investments in registered funds. They will thus have important consequences for, among others, registered funds of hedge funds.

Contact Information

If you have any questions or would like to learn more about these rules, please contact the Ropes & Gray lawyer who normally advises you.

