

SEC Staff Provides Guidance on Fund of Fund Fee Disclosure

The staff of the Division of Investment Management of the Securities and Exchange Commission ("SEC") has provided guidance in a Q&A format regarding fund of fund fee disclosure requirements (the "Q&A").¹ A copy of the Q&A is attached to this update.

In June 2006, the SEC adopted amendments to Forms N-1A, N-2, and N-3, adding a line item titled "Acquired Fund Fees and Expenses" to a registrant's fee table.² This new line item requires registrants that invest in certain other funds ("Acquired Funds") to disclose the fees and expenses associated with those investments.

The Q&A identifies categories of fees and expenses that a registrant can exclude and others that it is expected to include in the line item. For example:

- expenses associated with investments in structured finance vehicles, collateralized debt obligations, or other entities not traditionally considered pooled investment vehicles can be excluded;
- fees and expenses of money market funds or other sweep vehicles meeting the definition of Acquired Fund, in which cash collateral is invested in

connection with securities lending arrangements, can be excluded; and

- if a registrant invests in an Acquired Fund that invests in other funds, the fees and expenses incurred by the Acquired Fund from investing in such other funds generally can be excluded (although this exclusion does not apply to certain feeder funds).

The Q&A (**Attachment A**) also clarifies how to calculate certain other elements of the formula. Examples include how to count days and how to reflect market appreciation of assets.

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This update was authored by Anthony H. Zacharski (+1 860 524 3937; anthony.zacharski@dechert.com), Alan Rosenblat (+1 202 261 3332; alan.rosenblat@dechert.com), and Alex Kreonidis (+1 212 698 3801; alex.kreonidis@dechert.com).

¹ *Staff Responses to Questions regarding Disclosure of Fund of Funds Expenses* (May 23, 2007) (available at <http://www.sec.gov/divisions/investment/guidance/fundfundfaq.htm>).

² *Fund of Funds Investments*, Rel. No. IC-27399 (June 20, 2006) (the "Adopting Release"). For a summary of the Adopting Release, see *Dechert OnPoint*, July 2006 (Issue 8).

Practice group contacts

For more information, please contact the authors, one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financialservices.

Margaret A. Bancroft
New York
+1 212 698 3590
margaret.bancroft@dechert.com

Allison R. Beakley
Boston
+1 617 728 7124
allison.beakley@dechert.com

Sander M. Bieber
Washington, D.C.
+1 202 261 3308
sander.bieber@dechert.com

Stephen H. Bier
New York
+1 212 698 3889
stephen.bier@dechert.com

Daphne T. Chisolm
Charlotte
+1 704 339 3153
daphne.chisolm@dechert.com

Christopher D. Christian
Boston
+1 617 728 7173
christopher.christian@dechert.com

Timothy M. Clark
New York
+1 212 698 3652
timothy.clark@dechert.com

Elliott R. Curzon
Washington, D.C.
+1 202 261 3341
elliott.curzon@dechert.com

Douglas P. Dick
Newport Beach
+1 949 442 6060
douglas.dick@dechert.com

Steven S. Drachman
New York
+1 212 698 5627
steven.drachman@dechert.com

Ruth S. Epstein
Washington, D.C.
+1 202 261 3322
ruth.epstein@dechert.com

Susan C. Ervin
Washington, D.C.
+1 202 261 3325
susan.ervin@dechert.com

Joseph R. Fleming
Boston
+1 617 728 7161
joseph.fleming@dechert.com

Brendan C. Fox
Washington, D.C.
+1 202 261 3381
brendan.fox@dechert.com

Wendy Robbins Fox
Washington, D.C.
+1 202 261 3390
wendy.fox@dechert.com

David M. Geffen
Boston
+1 617 728 7112
david.geffen@dechert.com

David J. Harris
Washington, D.C.
+1 202 261 3385
david.harris@dechert.com

Robert W. Helm
Washington, D.C.
+1 202 261 3356
robert.helm@dechert.com

Jane A. Kanter
Washington, D.C.
+1 202 261 3302
jane.kanter@dechert.com

Stuart J. Kaswell
Washington, D.C.
+1 202 261 3314
stuart.kaswell@dechert.com

George J. Mazin
New York
+1 212 698 3570
george.mazin@dechert.com

Jack W. Murphy
Washington, D.C.
+1 202 261 3303
jack.murphy@dechert.com

John V. O'Hanlon
Boston
+1 617 728 7111
john.ohanlon@dechert.com

Fran Pollack-Matz
Washington, D.C.
+1 202 261 3442
fran.pollack-matz@dechert.com

Jeffrey S. Puretz
Washington, D.C.
+1 202 261 3358
jeffrey.puretz@dechert.com

Jon S. Rand
New York
+1 212 698 3634
jon.rand@dechert.com

Robert A. Robertson
Newport Beach
+1 949 442 6037
robert.robertson@dechert.com

Keith T. Robinson

Washington, D.C.
+1 202 261 3386
keith.robinson@dechert.com

Alan Rosenblat

Washington, D.C.
+1 202 261 3332
alan.rosenblat@dechert.com

Frederick H. Sherley

Charlotte
+1 704 339 3100
frederick.sherley@dechert.com

Patrick W. D. Turley

Washington, D.C.
+1 202 261 3364
patrick.turley@dechert.com

Brian S. Vargo

Philadelphia
+1 215 994 2880
brian.vargo@dechert.com

David A. Vaughan

Washington, D.C.
+1 202 261 3355
david.vaughan@dechert.com

Anthony H. Zacharski

Hartford
+1 860 524 3937
anthony.zacharski@dechert.com



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ATTACHMENT A

Staff Responses to Questions Regarding Disclosure of Fund of Funds Expenses

The staff of the Division of Investment Management has prepared the following responses to certain questions raised in connection with amendments to the fee table adopted in the Fund of Funds release in June 2006.¹ These amendments require funds to disclose in their fee tables the expenses of investing in other funds under a line item titled “Acquired Fund Fees and Expenses” (“AFFE”).

These responses represent the views of the staff of the Division of Investment Management. They are not a rule, regulation, or statement of the Securities and Exchange Commission, and the Commission has neither approved nor disapproved this information.

All responses refer to Item 3 of Form N-1A, but apply equally to similar items in Forms N-2 and N-3.

Question 1

Q: Instruction 3(f)(i) to Item 3 of Form N1-A requires a fund that invests in other funds (Acquired Funds) to disclose the fees and expenses associated with those investments. An “Acquired Fund” includes any company that would be an investment company under section 3(a) of the Investment Company Act but for the exceptions to that definition provided in sections 3(c)(1) and 3(c)(7) of the Act. In addition to hedge funds and other pooled investment vehicles discussed in the Adopting Release, some structured finance vehicles, such as collateralized debt obligations, may rely on section 3(c)(1) or 3(c)(7) of the Act. Must their expenses be included in an acquiring fund’s fee table?

A: No. AFFE is intended to include the expenses of investments in investment companies, hedge funds, private equity funds, and other entities traditionally considered pooled investment vehicles. Accordingly, the staff would not recommend enforcement action if a fund does not include in the fee table expenses associated with investments in structured finance vehicles, collateralized debt obligations, or other entities not traditionally considered pooled investment vehicles.

Question 2

Q: Must an Acquiring Fund include in its calculation of AFFE, expenses the Acquired Fund incurred through its investment in other investment companies?

A: No. Instruction 3(f)(iv) to Item 3 of Form N-1A provides that the total annual operating expense ratio used for purposes of calculating AFFE is the annualized expense ratio disclosed in the Acquired Fund’s most recent shareholder report. This expense ratio does not include expenses an Acquired Fund has incurred through its investment in other companies. (See question 3, however, with respect to disclosures for feeder funds.)

Question 3

Q: Are feeder funds required to include the AFFE in their prospectus fee tables?

A: Yes. Open-end feeder funds filing on Form N-1A must disclose in their fee tables the aggregate expenses of the feeder fund and the master fund (see Instruction 1(d)(i) to Item 3 of Form N-1A). The Form N-1A requirement pre-dates the new fund of fund disclosure amendments and has not been changed; the Commission added a similar Form N-2 requirement (see Instruction 10.h to Item 3 of Form N-2).

Question 4

Q: Instruction 3(f)(iv) to Item 3 of Form N-1A states that the annual operating expense ratio to be used for purposes of calculating AFFE is the ratio disclosed in an Acquired Fund's most recent shareholder report. Does "most recent" refer to the report available as of the Acquiring Fund's fiscal year end or as of the date of the Acquiring Fund's prospectus update in which the AFFE information will appear?

A: The term "most recent" refers to the Acquired Fund's shareholder report available at the time the Acquiring Fund calculates the AFFE. The Acquiring Fund should use the Acquired Fund's required expense ratio presented in the financial highlights table contained in the most recent annual or semi-annual report when the Acquiring Fund calculates the AFFE. If the semi-annual report is the most recent report, however, the Acquiring Fund must use an annualized expense ratio (see footnote 78 of the Adopting Release and accompanying text).

Question 5

Q: Instruction 3(f)(ii) to Item 3 of Form N-1A sets forth the formula for AFFE, which includes a calculation of the daily expense ratio and the number of days invested in an Acquired Fund. Should weekend days be included in these elements of the AFFE?

A: Yes, except for the calculation of average invested balance.

Daily Expense Ratio. The numerator in the AFFE formula includes a calculation of the daily expense ratio where "F" is the total annual expense ratio for each acquired fund and "FY" is the number of days in the fiscal year. Because F is an annualized expense ratio, FY must be either 365 or 366 days. Therefore, for purposes of calculating the daily expense ratio, weekend days must be included.

Average Invested Balance and Number of Days Invested in each Acquired Fund. The numerator in the AFFE formula also includes a calculation of average invested balance ("AI") in each acquired fund and the number of days invested in each Acquired Fund ("D"). Average invested balance is calculated based on, at a minimum, the monthly investment balance in the Acquired Fund. Therefore, average invested balance can be calculated using daily, weekly or monthly investment balances. The number of days invested is calculated using calendar days, which includes weekends (see Instruction 3(f)(v) to Item 3 of Form N-1A).

Question 6

Q: Instruction 3(f)(v) to Item 3 of Form N-1A states that the numerator for calculating average invested balance ("AI") for purposes of AFFE, is the amount initially invested in the Acquired Fund during the most recent fiscal year plus the amounts invested in the Acquired Fund measured no less frequently than monthly. Are the monthly measurements based on the market value of the investment in the Acquired Fund?

A: Yes. The amounts invested in an Acquired Fund are calculated using the value of the investment in the Acquired Fund as of the measurement date, which would take into account market appreciation (except for money market investments priced at amortized cost) (see footnote 72 of the Adopting Release). For example, if the Acquiring Fund calculates average daily investment in a registered open-end fund, the Acquiring Fund would base the value of that investment on the Acquired Fund's NAV at the end of each day, which would include any unrealized appreciation or loss with respect to the Acquiring Fund's investment.

Question 7

Q: As note above, an “Acquired Fund” includes any company that would be an investment company under section 3(a) of the Investment Company Act but for the exceptions to that definition provided in sections 3(c)(1) and 3(c)(7) of the Act. If an Acquiring Fund lends portfolio securities and invests the cash collateral received in a money market fund or other cash sweep vehicle that meets the definition of “Acquired Fund,” must the Acquiring Fund include the fees and expenses associated with the investment of the cash collateral in the calculation of AFFE?

A: No. Fees and expenses associated with investment of cash collateral received in connection with loans of portfolio securities in a money market fund or other cash sweep vehicle that meets the definition of Acquired Fund do not have to be included in the calculation of AFFE.

Question 8

Q: If an Acquiring Fund’s investment in an Acquired Fund is a debt rather than equity interest, must the Acquiring Fund include expenses associated with the debt in the AFFE?

A: An Acquiring fund investing in debt must include any transaction fees it paid in connection with acquiring or disposing of a debt interest in an Acquired Fund but not its pro rata portion of the cumulative expenses charged by the Acquired Fund because these expenses do not impact its debt interest in the Acquired Fund. See Instruction 3(f)(ii) to Item 3 of Form N-1A and Footnote 73 of the Adopting Release and accompanying text.

¹ Fund of Funds Investments, Investment Company Act Release No. 27399 (June 20, 2006) [71 FR 36640 (June 27, 2006)] (“Adopting Release”). The Release can be found at: <http://www.sec.gov/rules/final/2006/33-8713.pdf>.