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A legal update from Dechert's Financial Services Group

SEC Adopts New Fund of Fund Rules

The Securities and Exchange Commission ("SEC" or "Commission") has adopted rules 12d1-1, 12d1-2, and 12d1-3 that will increase the ability of funds to invest in the shares of other funds.[1] The Commission has also adopted amendments to the forms used to register funds to require additional disclosure in the prospectus fee table regarding the expenses of the funds in which the funds relying on these rules invest.

Background

Currently, the Investment Company Act of 1940 (the "Act") restricts the ability of funds to invest in other funds. Section 12d(1)(A) of the Act prohibits a fund from acquiring more than 3% of an acquired fund's outstanding voting stock, investing more than 5% of its total assets in securities issued by any one acquired fund, or investing more than 10% of its total assets in securities issued by all acquired funds.[2]

Section 12(d)(1)(B) prohibits a registered open-end fund from knowingly selling its shares to another fund if, after the sale, the acquiring fund will own more than 3% of the acquired fund's outstanding voting stock, or together with other funds would own more than 10% of the acquired fund's outstanding voting stock. The Act includes exceptions to these prohibitions, including exceptions for certain types of affiliated and unaffiliated fund of funds arrangements.

Investments in Money Market Funds

Rule 12d1-1 will allow funds to purchase and redeem shares of money market funds free from the limitations of section 12(d)(1). This rule is designed to allow funds to employ cash sweep arrangements where all or a portion of a fund's available cash is invested in a money market fund instead of being directly invested in short-term instruments. The acquired fund may be in the same fund complex as the acquiring fund, or in a different complex.

One condition of the rule is that the acquiring fund is either:

- Precluded from paying a sales charge or service fee in connection with the purchase, sale, or redemption of shares of the money market fund, or
- If such fees are paid, the acquiring fund's investment adviser must waive its advisory fee in an amount necessary to offset the amounts paid

The rule also will allow funds to invest in unregistered money market funds, provided the unregistered money market funds meet a variety of requirements specified in the Rule, including operating in compliance with Rule 2a-7 under the Act and being advised by an investment adviser registered with the Commission. Although a fund's investment in unregistered money market funds are not restricted by Section 12(d)(1), the Commission states in the Adopting Release that, "these investments are subject to the affiliate transaction restrictions in

1 *Fund of Funds Investments*, Rel. No. IC-27399 (June 20, 2006) (the "Adopting Release").

2 In Section 12(d)(1), the terms "acquiring fund" and "acquired fund" relate to the acquisition of fund shares and not necessarily the acquisition of all shares of a fund. For purposes of this client memo, the term "acquiring fund" includes other funds or companies controlled by the acquiring fund. *See* Sections 12(d)(1)(A), (B) and (G) of the Act.

3 *See* Sections 12(d)(1)(E), (F) and (G) of the Act.

the Act and rules thereunder and thus require exemptions from section 17(a) and rule 17d-1." Rule 12d1-1 specifically provides relief to funds with respect to both Section 17(a) and Rule 17d-1.

In addition, Rule 12d1-1 provides relief from the monitoring and recordkeeping requirements under Rules 17e-1 in circumstances where the broker-dealer and the acquiring fund become affiliates solely because of the acquiring fund's investment in a money market fund affiliated with the broker-dealer.

The rule does not limit advisory fees or require directors to make any special findings that investors are not paying multiple advisory fees for the same service. However, the Commission points out in a footnote in the Adopting Release that:

> Section 15(c) of the Act requires the board of directors to evaluate the terms (which would include fees, or the elimination of fees, for services by an acquired fund's adviser of any advisory contract) of any advisory contract. . . . Section 36(b) of the Act imposes on fund advisers a fiduciary duty with respect to their compensation. We believe that to the extent advisory services are being performed by another person, such as the adviser to an acquired money market fund, this fiduciary duty would require an acquiring fund's adviser to reduce its fee by the amount that represents compensation for the services performed by the other person.

Affiliated Funds of Funds

Rule 12d1-2 will allow an affiliated fund of funds to make investments in funds that are not part of the same group of investment companies as long as the investments are made in accordance with Section 12(d)(1)(A) or Section 12(d)(1)(F) of the Act. Rule 12d1-2 will also provide an exemption from Section 12(d)(1)(G) of the Act to allow affiliated funds of funds to invest directly in stocks, bonds, and other securities. Finally, Rule 12d1-2 will allow affiliated funds of funds to invest in money market funds in accordance with Rule 12d1-1.

Unaffiliated Funds of Funds

Rule 12d1-3 would provide funds greater flexibility in structuring sales loads. Section 12(d)(1)(F) of the Act allows a registered fund to invest all of its assets in other registered funds if the acquiring fund would own no more than 3% of any acquired fund and the acquiring fund's sales load is not greater than 1.5%. Rule 12d1-3 will allow sales loads to exceed 1.5% provided that the aggregate sales load an investor pays is not greater than the NASD established limits on sales loads for funds of funds.

Amendments to Disclosure Forms

Form N-1A

Form N-1A has been amended to require any registered open-end fund investing in shares of another fund to include in its prospectus fee table an additional line item entitled "Acquired Fund Fees and Expenses," disclosing the fees and expenses incurred indirectly as a result of investment in shares of one or more acquired funds. The revised Form N-1A also specifies how this amount is to be calculated and specifies that, in circumstances when the amount of the fees and expenses borne indirectly does not exceed 0.01% of the average net assets of the fund, the disclosure can be included in "Other Expenses" rather than in a separate line item in the fee table.

Form N-2

Form N-2 has been amended to require a registered closed- end fund (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), as a line item in its fee table. Each acquiring closed-end fund will be required to determine expenses attributable to its investments in acquired funds during the most recent fiscal year, together with any investments it intends to make in acquired funds with the proceeds of the offering.

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4 Adopting Release at n. 52.

Forms N-3, N-4, and N-6

Similar amendments have been made to Forms N-3, N-4, and N-6.

Effective and Compliance Dates

The effective date of the rules and Form amendments is July 31, 2006.

The compliance dates for 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 of effective registration statements on those Forms filed on or after January 2, 2007, must include the disclosure required by the amendments.

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