K&LNG Alert

JULY 2006

Investment Management

SEC Adopts New Fund of Funds Rules

On June 20, 2006, the Securities and Exchange Commission (the "SEC") adopted three new rules that expand the ability of all funds to invest in money market funds and generally enlarge the investment scope of funds of funds. New Rules 12d1-1, 12d1-2, and 12d1-3 under the Investment Company Act of 1940 (the "1940 Act") create exemptions that: (i) expand a fund's ability to invest in other registered and unregistered money market funds, both affiliated and unaffiliated, and (ii) expand the investment abilities of funds of funds, including the ability to invest in non-fund securities. The rules largely codify a number of existing exemptive orders permitting cash sweep and fund of funds arrangements. The SEC adopted these rules substantially as they were originally proposed in October 2003, and the new rules will go into effect on July 31, 2006. In addition, the SEC amended fund registration forms to require each fund that invests in other funds to disclose the cumulative amount of expenses charged by the acquiring fund and any fund in which it invests.

BACKGROUND

Section 12(d)(1) of the 1940 Act places significant restrictions on a fund's ability to invest in other funds in order to prevent abusive practices and fee layering relating to fund "pyramiding" arrangements. Section 12(d)(1)(A), the most restrictive of these provisions, prohibits a fund from acquiring more than 3% of a registered fund's outstanding voting stock, investing more than 5% of its total assets in a given registered fund, and investing more than 10% of its total assets in registered funds in the aggregate. (The 3% limitation applies to purchases by registered and unregistered funds.) Similarly, Section 12(d)(1)(B) contains prohibitions on the sale by mutual funds of their shares to other funds.

However, Section 12(d)(1)(F) and Section 12(d)(1)(G) create statutory exceptions for funds that invest in unaffiliated and affiliated funds, respectively, under several conditions that fund sponsors have found increasingly burdensome or unworkable. Thus, funds have often sought exemptive relief for investing in other funds, and such relief was routinely granted for money market fund "cash sweep" investments and sometimes granted for funds of funds that diverged from the statutory exceptions. The new rules obviate the need for some forms of exemptive relief, particularly cash sweep orders, and permit funds of funds greater freedom to invest in other funds and securities. Of course, any investments permitted by the new rules must be consistent with the investing fund's investment policies and limitations.

RULE 12D1-1: INVESTMENTS IN MONEY MARKET FUNDS

New Rule 12d1-1 permits all funds to invest unlimited amounts of cash in registered and unregistered money market funds (whether or not affiliated) under specified conditions. The rule applies to money market fund investments by mutual funds, closed-end funds (including business development companies) and unregistered funds relying on Section 3(c)(1) or 3(c)(7) under the 1940 Act. This rule eliminates the need for individual "cash sweep" exemptive orders.

The rule provides exemptions not only from Section 12(d)(1) but also from Section 17(a) of the 1940 Act and Rule 17d-1, which regulate transactions between registered funds and their affiliates. Absent the exemptions, these provisions could prohibit a fund from investing in a money market fund in the same fund complex or acquiring more than 5% of the shares of a money market fund in another complex.

The exemption is conditioned on the acquiring fund not paying any sales charge or service fee, or waiving advisory fees to offset any such fees. However, unlike prior exemptive orders, Rule 12d1-1 does not place restrictions on advisory fees or require special board findings that investors are not paying duplicative fees. In addition, the rule permits acquiring funds to pay commissions, fees, and other remuneration to second-tier affiliated broker-dealers in connection with transactions in portfolio securities without meeting the quarterly board review and record keeping requirements of Rule 17e-1, where the affiliation solely results from the acquiring fund's investment in a money market fund whose adviser is affiliated with the broker-dealer.

The rule also permits investments in unregistered money market funds, provided that they "operate like" registered money market funds. The acquiring fund must reasonably believe that the unregistered money market fund satisfies certain conditions of a registered money market fund—in essence, that it invests only in those investments in which a money market fund may invest under Rule 2a-7 and undertakes to comply with the provisions of Rule 2a-7. The adviser to the unregistered money market fund also must be a SEC-registered investment adviser.

RULE 12D1-2: INVESTMENTS OF FUNDS OF AFFILIATED FUNDS IN OTHER TYPES OF SECURITIES

Section 12(d)(1)(G) of the 1940 Act permits mutual funds and unit investment trusts ("UITs") to acquire unlimited shares in other mutual funds or UITs in the same fund complex, as well as government securities and short-term paper. However, such an affiliated fund of funds is restricted in the other types of securities it can hold. In addition, the acquired funds may not themselves be funds of funds and thus may not rely upon Section 12(d)(1)(F) or Section 12(d)(1)(G) to invest in shares of other funds. Section 12(d)(1)(G) also places on distribution expenses the limits set forth in NASD Conduct Rule 2830.

New Rule 12d1-2 permits funds that rely on Section 12(d)(1)(G) to invest in unaffiliated funds, subject to the limits of Sections 12(d)(1)(A) and (F). It also permits them to invest in affiliated or unaffiliated "money market funds" under Rule 12d1-1, as well as investments in securities offered by issuers other than funds, such as stocks, bonds and other types of "securities" (as that term is defined under the 1940 Act), provided that the investments are consistent with the funds' investment objectives and policies. Rule 12d1-2 could be viewed as not permitting funds of affiliated funds to invest in derivatives that are not securities, which would preclude investment strategies such as the "equitization" of cash through broad-based index futures. However, as the release did not discuss this point, it is not clear whether the limitation to "securities" was intentional on the SEC's part. Registrants may want to seek clarification before proceeding in this area.

RULE 12D1-3: SALES CHARGE FLEXIBILITY FOR FUNDS OF UNAFFILIATED FUNDS

Section 12(d)(1)(F), although not widely used, permits a registered fund to invest in unaffiliated registered funds if, among other conditions, the acquiring fund and its affiliates would not own more than 3% of the total outstanding stock of any such acquired fund, and the sales charge on the acquiring fund's shares is not greater than 1½ %.[1] New Rule 12d1-3 permits a registered fund that relies on Section 12(d)(1)(F) to levy sales charges and service fees up to the applicable limits set forth in NASD Conduct Rule 2830. While loosening the sales charge restrictions of Section 12(d)(1)(F), the new rule does not alter the other limitations that have resulted in relatively few funds relying on this section.

NEW DISCLOSURE REQUIREMENTS

In addition, the SEC significantly amended fund registration forms to require all funds that invest in other funds, and in particular funds of funds, to disclose the acquiring fund's *pro rata* portion of the cumulative net expenses charged by funds in which the acquiring fund invests as a separate line item in the fee table, even if the acquiring fund does not rely on the new rules. The SEC also adopted highly detailed new instructions for calculating the amount of acquired funds' fees and expenses. Generally, the acquiring fund must aggregate the total annual operating expenses of acquired funds and related transaction fees. The expense calculations must

---

[1] Other conditions require that the acquired fund not be obligated to redeem more than 1% of its outstanding securities held by the acquiring fund in any period of less than 30 days, and that the acquiring fund either "mirror" vote the shares of the acquired fund or ask the acquiring fund's shareholders for voting instructions.

include expenses of private funds excepted from registration by Section 3(c)(1) or 3(c)(7) of the 1940 Act, if any. The new requirements provide an exception if acquired fund expenses are less than 0.01% (one basis point), in which case the expenses should be reflected in general fund expenses. The instructions do not make clear whether a registrant whose adviser offsets such expenses through a partial rebate of its own advisory fee can disclose only the net expense of the investment in another fund.

Form N-1A (which applies to mutual funds) was amended to add a new line item called "Acquired Fund Fees and Expenses" in the total fund operating expenses section of the prospectus fee table, in which the acquired funds' expenses will be expressed as a percentage of average net assets. These expenses must also be included in the "Example" portion of the fee table, which discloses the cumulative amount of fund expenses for 1, 3, 5, and 10 years based on a hypothetical investment of $10,000 and an annual 5% return.

Similarly, Form N-2 (which covers closed-end funds) was amended to require registered closed-end funds to include, as a line item in the fee table, their "*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)."

In particular, this applies to funds of hedge funds, which may face significant challenges in preparing the line item. Because of the nature and variety of hedge fund performance fees, the detailed calculations must be based on historical expenses. The SEC acknowledged that historical hedge fund expenses and future expenses could vary due to the impact of acquired hedge funds' performance fees. Thus, the SEC required funds of hedge funds to add a disclaimer about the variable nature of hedge fund fees and to add a footnote to the new item that discloses the "typical performance fee charged by acquired hedge funds" in which they invest. In addition, the SEC permitted funds to exclude from the expense ratio in the fee table specified performance fees that may be unrelated to the costs of investing in a fund of funds, such as fees that are calculated solely on the realization or distribution of gains, which are typically paid upon liquidation of the fund.[2]

New registration statements on Forms N-1A, N-2, N-3, N-4, and N-6, as well as post-effective amendments thereto that are annual updates, filed on or after January 2, 2007, must comply with the amended disclosure requirements. Due to the nature of these changes, we recommend that funds consult with their accountants and legal counsel well in advance of a fund's deadline regarding compliance with the instructions and calculation of the newly required expense amounts.

Mark D. Perlow
415.249.1070
mperlow@klng.com

George J. Zornada
617.261.3231
gzornada@klng.com

Helen C. Kuo
415.249.1044
hkuo@klng.com

---

[2] The SEC similarly amended Forms N-3, N-4, and N-6, which apply to insurance company separate accounts.

If you have questions or would like more information about K&LNG's Investment Management Practice, please contact one of our lawyers listed below:

BOSTON

Joel D. Almquist	617.261.3104	jalmquist@klng.com
Michael S. Caccese	617.261.3133	mcaccese@klng.com
Mark P. Goshko	617.261.3163	mgoshko@klng.com
Thomas Hickey III	617.261.3208	thickey@klng.com
Nicholas S. Hodge	617.261.3210	nhodge@klng.com
Derek M. Meisner	617.261.3114	dmeisner@klng.com
George Zornada	617.261.3231	gzornada@klng.com

LONDON

Philip Morgan	+44.20.7360.8123	pmorgan@klng.com

LOS ANGELES

William P. Wade	310.552.5071	wwade@klng.com

NEW YORK

Robert J. Borzone, Jr.	212.536.4029	rborzone@klng.com
Jeffrey M. Cole	212.536.4823	jcole@klng.com
Alan M. Hoffman	212.536.4841	ahoffman@klng.com
Ricardo Hollingsworth	212.536.4859	rhollingsworth@klng.com
Beth R. Kramer	212.536.4024	bkramer@klng.com
Richard D. Marshall	212.536.3941	rmarshall@klng.com
Keith W. Miller	212.536.4045	kmiller@klng.com
Scott D. Newman	212.536.4054	snewman@klng.com

SAN FRANCISCO

Elaine A. Lindenmayer	415.249.1042	elindenmayer@klng.com
David Mishel	415.249.1015	dmishel@klng.com
Mark D. Perlow	415.249.1070	mperlow@klng.com
Richard M. Phillips	415.249.1010	rphillips@klng.com

WASHINGTON

Clifford J. Alexander	202.778.9068	calexander@klng.com
Diane E. Ambler	202.778.9886	dambler@klng.com
Mark C. Amorosi	202.778.9351	mamorosi@klng.com
Catherine S. Bardsley	202.778.9289	cbardsley@klng.com
Arthur J. Brown	202.778.9046	abrown@klng.com
Arthur C. Delibert	202.778.9042	adelibert@klng.com
Jennifer R. Gonzalez	202.778.9286	jgonzalez@klng.com
Robert C. Hacker	202.778.9016	rhacker@klng.com
Kathy Kresch Ingber	202.778.9015	kingber@klng.com
Michael J. King	202.778.9214	mking@klng.com
Rebecca H. Laird	202.778.9038	rlaird@klng.com
Deborah A. Linn	202.778.9874	dlinn@klng.com
Cary J. Meer	202.778.9107	cmeer@klng.com
Dean E. Miller	202.778.9371	dmiller@klng.com
R. Charles Miller	202.778.9372	cmiller@klng.com
Charles R. Mills	202.778.9096	cmills@klng.com
R. Darrell Mounts	202.778.9298	dmounts@klng.com
C. Dirk Peterson	202.778.9324	dpeterson@klng.com
David Pickle	202.778.9887	dpickle@klng.com
Alan C. Porter	202.778.9186	aporter@klng.com
Theodore L. Press	202.778.9025	tpress@klng.com
Francine J. Rosenberger	202.778.9187	francine.rosenberger@klng.com
Robert H. Rosenblum	202.778.9464	rrosenblum@klng.com
William A. Schmidt	202.778.9373	william.schmidt@klng.com
Lori L. Schneider	202.778.9305	lschneider@klng.com
Lynn A. Schweinfurth	202.778.9876	lschweinfurth@klng.com
Donald W. Smith	202.778.9079	dsmith@klng.com
Fatima S. Sulaiman	202.778.9223	fsulaiman@klng.com
Martin D. Teckler	202.778.9890	mteckler@klng.com
Roger S. Wise	202.778.9023	rwise@klng.com
Robert A. Wittie	202.778.9066	rwittie@klng.com
Robert J. Zutz	202.778.9059	rzutz@klng.com

K&L® Challenge us.®

Kirkpatrick & Lockhart Nicholson Graham LLP

www.klng.com

BOSTON • DALLAS • HARRISBURG • LONDON • LOS ANGELES • MIAMI • NEWARK • NEW YORK • PALO ALTO • PITTSBURGH • SAN FRANCISCO • WASHINGTON