

fund, which is an open-end fund and a conduit to the "master" fund.<sup>18</sup>

#### *Unaffiliated Fund of Funds*

**Arrangements.** The Act also permits a registered fund to take small positions in an unlimited number of other funds (an "unaffiliated fund of funds").<sup>19</sup> A fund taking advantage of the exception provided in section 12(d)(1)(F) of the Act (and its affiliated persons) may acquire no more than three percent of another fund's securities;<sup>20</sup> cannot charge a sales load greater than 1½ percent;<sup>21</sup> is restricted in its ability to redeem shares of the acquired fund;<sup>22</sup> and is unable to use its voting power to influence the outcome of shareholder votes held by the acquired fund.<sup>23</sup> The exception was designed to give limited relief to fund of funds arrangements in existence in 1970 when section 12(d)(1) was amended, subject to restrictions designed to prevent abuses.<sup>24</sup>

#### *Affiliated Fund of Funds*

**Arrangements.** The Act also permits a fund to invest in one or more funds in the same fund complex. Enacted as part of the National Securities Markets Improvement Act of 1996 ("NSMIA"),<sup>25</sup>

section 12(d)(1)(G) permits a registered open-end fund or UIT to acquire an unlimited amount of shares of other registered open-end funds and UITs that are part of the same "group of investment companies."<sup>26</sup> A fund taking advantage of this exception (an "affiliated fund of funds") is restricted in the types of other securities it can hold in addition to shares of registered funds in the same group of investment companies.<sup>27</sup> The acquired funds must have a policy against investing in shares of other funds in reliance on section 12(d)(1)(F) or 12(d)(1)(G) (to prevent multi-tiered structures),<sup>28</sup> and overall distribution expenses are limited (to prevent excessive sales loads).<sup>29</sup> Under this provision, which codified Commission exemptive orders,<sup>30</sup> several

large fund complexes offer a fund of funds, which allocates and periodically reallocates its assets among funds in the complex.<sup>31</sup>

## II. Discussion

Since 1940 we have provided limited relief for funds to acquire shares of other funds when the proposed arrangements did not present the risk of abuses that section 12(d)(1) was designed to prevent. We issued those orders under our general exemptive authority in section 6(c) of the Act.<sup>32</sup> In 1996, when Congress added section 12(d)(1)(G), it gave us specific authority to exempt any person, security, or transaction, or any class or classes of transactions, from section 12(d)(1) if the exemption is consistent with the public interest and the protection of investors.<sup>33</sup> The House Report accompanying NSMIA urged the Commission to use the additional exemptive authority under section 12(d)(1)(J) "in a progressive way as the fund of funds concept continues to evolve over time."<sup>34</sup>

Today we are proposing three new rules. Two of these provide exemptions

<sup>18</sup> See H.R. Rep. No. 622, 104th Cong., 2d Sess., at 41 (1996) ("H.R. Rep. No. 622"); Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master Feeder Funds; Voting on Distribution Plans; Final Rules and Proposed Rule, Investment Company Act Release No. 20915 (Feb. 23, 1995) [60 FR 11876, 11876-77 (Mar. 2, 1995)]; Division of Investment Management, Securities and Exchange Commission, Hub and Spoke Funds: A Report Prepared by the Division of Investment Management, submitted with letter to the Honorable John D. Dingell, Chairman, Committee on Energy and Commerce, U.S. House of Representatives from Richard C. Breeden, Chairman, Securities and Exchange Commission (Apr. 15, 1992), available in LEXIS, Fedsec library, Noact File.

<sup>19</sup> See 15 U.S.C. 80a-12(d)(1)(F).

<sup>20</sup> A registered fund relying on section 12(d)(1)(F) may acquire securities issued by another fund if, immediately after acquiring the securities, not more than three percent of the total outstanding stock of the acquired fund is owned by the acquiring fund and all its affiliates. See 15 U.S.C. 80a-12(d)(1)(F)(i). Section 12(d)(1)(F) does not limit acquiring fund investments in securities other than those issued by other funds.

<sup>21</sup> A fund relying on section 12(d)(1)(F) may not offer or sell (or propose to offer or sell through a principal underwriter) a security it issues at a public offering price that includes a sales load of more than 1½ percent. See 15 U.S.C. 80a-12(d)(1)(F)(ii).

<sup>22</sup> A fund whose shares are acquired pursuant to section 12(d)(1)(F) is not obligated to redeem more than 1 percent of those securities during any period of less than 30 days. 15 U.S.C. 80a-12(d)(1)(F).

<sup>23</sup> Section 12(d)(1)(F), by reference to section 12(d)(1)(E), requires the acquiring fund to vote shares of an acquired fund either by seeking instructions from the acquiring fund's shareholders, or to vote the shares in the same proportion as the vote of all other shareholders of the acquired fund. *Id.*

<sup>24</sup> See H.R. Rep. No. 1382, *supra* note 8, at 11.

<sup>25</sup> Pub. L. No. 104-290, 110 Stat. 3416 (1996).

<sup>26</sup> See 15 U.S.C. 12(d)(1)(G). For purposes of the exception, the term "group of investment companies" means "any 2 or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services." 15 U.S.C. 80a-12(d)(1)(G)(ii).

<sup>27</sup> In addition to investing in securities of registered funds in the same group of investment companies, the Act permits these funds to invest only in government securities and short-term paper. See 15 U.S.C. 80a-12(d)(1)(G)(i)(II).

<sup>28</sup> See 15 U.S.C. 80a-12(d)(1)(G)(i)(IV).

<sup>29</sup> See 15 U.S.C. 80a-12(d)(1)(G)(i)(III). The provision permits a fund to invest in shares of another fund only if either (i) the acquiring fund does not charge a sales load or distribution-related fee or does not pay (and is not assessed) sales loads or distribution-related fees on securities of the acquired fund, or (ii) the aggregate distribution-related fees (or loads) charged by the acquiring fund on its securities and paid by the acquiring fund on acquired fund securities are not excessive under rules adopted under section 22(b) [15 U.S.C. 80a-22(b)] or 22(c) [15 U.S.C. 80a-22(c)] by a securities association registered under section 15A of the Securities Exchange Act of 1934 (the "Exchange Act") [15 U.S.C. 78o-3] or the Commission. The NASD has adopted limits on sales loads and distribution-related fees applicable to funds as well as to funds of funds. See NASD Rule 2830(d)(2), (3) ("NASD Sales Charge Rule").

Under the NASD Sales Charge Rule for funds of funds, if neither the acquiring nor acquired fund has an asset-based sales charge (12b-1 fee), the maximum front-end and deferred sales charge that can be charged by the acquiring fund, the acquired fund, and both in combination cannot exceed 8.5 percent of the offering price of the shares. See NASD Sales Charge Rule 2830(d)(3)(A). Any acquiring or acquired fund that has an asset-based sales charge must individually comply with the sales charge limitations on funds with an asset-based sales charge, provided, among other conditions, that if both funds have an asset-based sales charge, the maximum aggregate asset-based sales charge cannot exceed .75 of 1 percent per year of the average annual net assets of the fund; and the maximum aggregate sales load may not exceed 7.25 percent of the amount invested, or 6.25 percent if either fund pays a service fee. See NASD Sales Charge Rule 2830(d)(2)(A), (B).

<sup>30</sup> See Vanguard STAR Fund, Investment Company Act Release No. 21372 (Sept. 22, 1995) [60 FR 50656 (Sept. 29, 1995)] (notice), Investment Company Act Release No. 21426 (Oct. 18, 1995) (order) (revising conditions on the 1985 Vanguard Order); T. Rowe Price Spectrum Fund, Investment Company Act Release No. 21371 (Sept. 22, 1995)

[60 FR 50654 (Sept. 29, 1995)] (notice), Investment Company Act Release No. 21425 (Oct. 18, 1995) (order) (revising conditions on the 1989 T. Rowe Price Order); T. Rowe Price Spectrum Fund, Investment Company Act Release No. 17198 (Oct. 31, 1989) [54 FR 47010 (Nov. 8, 1989)] (notice), Investment Company Act Release No. 17242 (Nov. 29, 1989) (order) ("1989 T. Rowe Price Order"); Vanguard Special Tax-Advanced Retirement Fund, Investment Company Act Release No. 14153 (Sept. 12, 1984) [49 FR 36582 (Sept. 18, 1984)] (notice), Investment Company Act Release No. 14361 (Feb. 7, 1985) (order) ("1985 Vanguard Order").

<sup>31</sup> See, e.g., T. Rowe Price, Retirement Funds, Prospectus 1-4 (Mar. 14, 2003).

<sup>32</sup> 15 U.S.C. 80a-6(c). Section 6(c) provides that "[t]he Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

<sup>33</sup> See NSMIA, *supra* note 25, § 202 (codified at 15 U.S.C. 80a-12(d)(1)(J)). Congress added section 12(d)(1)(J) to resolve questions regarding the scope of our authority under section 6(c). See 1985 Vanguard Order, *supra* note 30, dissenting opinion of Commissioners Treadway and Peters (concluding that applicants failed to establish an adequate record on which Commission could find exemption from section 12(d)(1)(A) to meet the standards of section 6(c) of the Act).

<sup>34</sup> H.R. Rep. No. 622, *supra* note 18, at 44-45. The House Report explained that, in exercising its exemptive authority, the Commission should consider factors that relate to the protection of investors, including the extent to which a proposed arrangement is subject to conditions that are designed to address conflicts of interest and overreaching by a participant in the arrangement, so as to avoid the abuses that gave rise to the initial adoption of the Act's restrictions against funds investing in other funds. See *id.* at 45.