

in addition to the statutory exceptions to the fund of funds limits. The third provides an exemption from a statutory condition for a fund of funds arrangement. These rules would codify and expand upon a number of exemptive orders we have issued that permit funds to invest in other funds. We also are proposing amendments to Forms N-1A, N-2, N-3, N-4, and N-6 that will require funds of funds to disclose in their prospectuses the expenses of acquired funds, which investors in a fund of funds will bear indirectly.

A. Rule 12d1-1: Investments in Money Market Funds

We are proposing a new rule that would permit funds to invest in shares of money market funds. Rule 12d1-1 would permit "cash sweep" arrangements in which a fund invests all or a portion of its available cash in a money market fund rather than directly in short-term instruments.³⁵ Since 1982, we have issued more than 80 exemptive orders permitting these types of arrangements.³⁶ Funds have represented that use of a money market fund may be expected to achieve greater efficiencies, reduce fund management expenses, and increase returns.³⁷

³⁵ A fund may have uninvested cash from new purchases of shares by investors, receipt of dividends and interest from portfolio investments, and matured investments, as well as cash collateral from securities lending activities. The proposed rule would permit a fund to invest in one or more money market funds.

³⁶ See, e.g., Diamond Hill Funds, Investment Company Act Release No. 26058 (May 28, 2003) [68 FR 33213 (June 3, 2003)] (notice); Investment Company Act Release No. 26079 (June 24, 2003) (order); SEI Index Funds, Investment Company Act Release No. 26008 (Apr. 22, 2003) [68 FR 22423 (Apr. 28, 2003)] (notice); Investment Company Act Release No. 26048 (May 19, 2003) (order). These orders contain a number of conditions, including: (i) Shares of the acquired money market fund will not be subject to sales loads, distribution-related fees, or service fees, or if they are, the acquiring fund's adviser will waive its advisory fee in an amount to offset the amount of fees incurred by the acquiring fund; (ii) before approving any advisory contract for the acquiring fund, its board of directors, including a majority of directors who are not interested persons under section 2(a)(19) of the Act [15 U.S.C. 80a-2(a)(19)] ("independent directors"), will consider the extent to which (if any) the advisory fees charged by the adviser should be reduced to account for reduced services as a result of investing cash in the money market fund; (iii) the acquiring fund's investment in money market funds will be limited to 25 percent of the acquiring fund's total assets; (iv) the acquiring fund's investment in the money market fund is consistent with the acquiring fund's policies as set forth in its registration statement; (v) the acquiring fund and money market fund are advised by the same adviser (or are part of the same group of investment companies); and (vi) the acquired money market fund will not acquire securities in another fund in excess of the limits of section 12(d)(1)(A) of the Act.

³⁷ See, e.g., Pioneer America Income Trust, First Amended and Restated Application pursuant to

Moreover, use of a money market fund may permit fund portfolio managers to focus on the management of the principal investments of the fund.

Fund investments in money market funds, which did not exist in 1940, do not appear to raise the concerns that underlie section 12(d)(1). Money market funds are designed to accommodate significant daily inflows and outflows of cash and therefore their management seems unlikely to be influenced by investors who could threaten large redemptions.³⁸ There is little value to obtaining a control position in a money market fund, and money market funds do not control valuable brokerage commissions that can be directed to affiliates.³⁹ A fund's investment in shares of a money market fund does, however, present the opportunity for layering of advisory fees and distribution expenses, which we propose to address as discussed in section II.D below.

1. Scope of Exemption

(a) *Affiliated Money Market Funds.* Funds that intend to invest in money market funds in the same fund complex ("affiliated money market funds") also need exemptions from sections 17(a)⁴⁰

Section 12(d)(1)(J) of the Investment Company Act of 1940, section IV (filed June 4, 2002) ("Pioneer Application"); Bear Stearns Funds, *et al.*, Amended Application for an Order under Section 12(d)(1)(J) of the Investment Company Act of 1940, section III.C (filed Jan. 8, 1999).

³⁸ See Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 21837 (Mar. 21, 1996) [61 FR 13956, 13957 (Mar. 28, 1996)] (among money market fund objectives is preservation of capital and liquidity); Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 17589 at text preceding n.7 (July 17, 1990) [55 FR 30239 (July 25, 1990)] (many investors use money market accounts as alternatives to checking accounts).

³⁹ We note that in the context of rule 2a-7, the Commission has permitted an exception that allows money market funds to invest in other money market funds in excess of the diversification requirements for other issuers provided the board of directors of the acquiring fund reasonably believes that the acquired fund is in compliance with rule 2a-7. See 17 CFR 270.2a-7(c)(4)(ii)(E). Under rule 2a-7, shares of money market funds are considered first-tier securities that without the exception would be subject to the rule's issuer diversification standards for first-tier securities. See 17 CFR 270.2a-7(a)(12).

⁴⁰ Section 17(a)(1) prohibits an affiliated person of a registered fund, a promoter or principal underwriter for a registered fund, or an affiliated person of the foregoing, acting as principal, from selling securities or other property to the fund, unless (A) the buyer is the issuer of the securities, (B) the seller is the issuer of the securities and the securities are part of a general offering to the holders of a class of the seller's securities, or (C) a depositor has deposited the securities with the trust of a UIT or periodic payment plan. 15 U.S.C. 80a-17(a)(1). Section 17(a)(2) prohibits an affiliated person from knowingly buying from a registered fund (or companies it controls) any security or other property unless the seller is the issuer of the

and 17(d) of the Act, and rule 17d-1 thereunder,⁴¹ which restrict transactions and joint arrangements with affiliated persons. In addition, a fund that acquires more than five percent of the securities of a money market fund in another fund complex would become an affiliated person of the money market fund, and would need relief from these section 17 prohibitions before making any additional investments in the money market fund.⁴² Proposed rule 12d1-1 would provide this relief. An acquiring fund's purchase and redemption of

securities. 15 U.S.C. 80a-17(a)(2). Affiliated persons of a fund include any person directly or indirectly controlling, controlled by, or under common control with the fund. See 15 U.S.C. 80a-2(a)(3)(C) (definition of "affiliated person"). Most funds today are organized by an investment adviser that advises or provides administrative services to a number of other funds in the same fund complex. Funds in a fund complex are under the common control of an investment adviser or other person when the adviser or other person exercises a controlling influence over the management or policies of the funds. See 15 U.S.C. 80a-2(a)(9). Not all advisers control funds they advise. The determination of whether a fund is under the control of its adviser, officers, or directors depends on all the relevant facts and circumstances. See Investment Company Mergers, Investment Company Act Release No. 25259, n.14 (Nov. 8, 2001) [66 FR 57602 (Nov. 15, 2001)]. For purposes of this release, we presume that funds in a fund complex are under common control because funds that are not affiliated persons would not require, and thus not rely on, the proposed exemptions from section 17(a) and rule 17d-1.

⁴¹ Section 17(d) of the Act makes it unlawful for an affiliated person of a registered fund ("first-tier affiliate"), an affiliated person of an affiliated person of a registered fund ("second-tier affiliate"), the fund's principal underwriters, or affiliated persons of the fund's principal underwriters, acting as principal, to effect any transaction in which the fund, or a company it controls, is a joint or a joint and several participant "in contravention of such rules and regulations as the Commission may prescribe for the purpose of limiting or preventing participation by such registered or controlled company on a basis different from or less advantageous than that of such other participant." 15 U.S.C. 80a-17(d). Rule 17d-1(a) prohibits first- and second-tier affiliates of a registered fund, the fund's principal underwriter, and affiliated persons of the fund's principal underwriter, acting as principal, from participating in or effecting any transaction in connection with any joint enterprise or other joint arrangement or profit-sharing plan in which the fund (or company it controls) is a participant "unless an application regarding such joint enterprise, arrangement or profit-sharing plan has been filed with the Commission and has been granted by an order * * *." 17 CFR 270.17d-1. When an acquiring fund purchases securities from an affiliated money market fund on the advice of an adviser who also manages the money market fund, the arrangement and transactions could be deemed to be a joint enterprise in which the two funds and the adviser are joint participants.

⁴² An affiliated person of a fund includes: (i) Any person directly or indirectly owning, controlling, or holding with power to vote, five percent or more of the outstanding voting securities of the fund; and (ii) any person five percent or more of whose assets or securities are directly or indirectly owned, controlled, or held with power to vote by the fund. See 15 U.S.C. 80a-2(a)(3)(A), (B) (definition of "affiliated person").