

required a fund relying on the exemption to invest all of its assets in shares of funds in the same group of investment companies, and permitted other investments to include only government securities and short-term paper, which would provide the fund with a source of liquidity to redeem shares.⁷⁷ Congress encouraged us, however, to provide exemptions from these limitations "in a progressive way," taking into account factors that related to the protection of investors.⁷⁸

We propose to permit an affiliated fund of funds to invest in any other securities (*i.e.*, securities not issued by a fund).⁷⁹ This exemption would permit an affiliated fund of funds to invest directly in stocks, bonds, and other types of securities if such investments are consistent with the fund's investment policies. These investments would allow an acquiring fund greater flexibility to meet investment objectives that may not be met as well by investments in other funds in the same fund group, while the investments would not seem to present any additional concerns that section 12(d)(1)(G) was intended to address.⁸⁰

A potentially significant consequence of the proposed rule would be that an equity fund or bond fund could invest any portion of its assets in an affiliated fund if such an acquisition is consistent with the investment policies of the fund and the restrictions of the rule. Our exemptive orders have permitted arrangements under which fund complexes have, for example, established a fund investing in foreign securities and made that fund available exclusively to other funds in the fund complex. The other funds used an investment in the international fund to obtain exposure to foreign securities consistent with their investment objectives.⁸¹ Investments in an affiliated fund by a fund investing in other types of securities would not seem to raise any greater concerns than would an investment by a fund investing entirely

in shares of affiliated funds. We note that section 12(d)(1)(G) already addresses concerns regarding excessive distribution-related fees in its fee limitations.⁸² In addition, as noted above, we would address the concerns regarding excessive advisory fees through the proposed amendments to Forms N-1A and N-2 requiring disclosure of acquired fund expenses.⁸³ We seek comment on this proposal. Would any concerns arise if an affiliated fund of funds could invest directly in stocks, bonds, or other types of securities?

3. Investments in Money Market Funds

Proposed rule 12d1-2 would permit an affiliated fund of funds to invest in affiliated or unaffiliated money market funds in reliance on proposed rule 12d1-1, which, as discussed above, is designed to permit cash sweep arrangements involving money market funds.⁸⁴ An affiliated fund of funds currently is permitted to invest in money market funds in the same fund complex. The proposed rule would permit an affiliated fund of funds to invest in money market funds in a different fund complex. This will allow affiliated funds of funds the same opportunities as any other fund to invest in a cash sweep arrangement that will provide the greatest benefit to the acquiring fund. We are conditioning the investment on compliance with proposed rule 12d1-1 in order to ensure that the same limitations on sales loads and distribution expenses apply to any fund's investment in a money market fund.

We request comment on proposed rule 12d1-2. Are there reasons not to permit an affiliated fund of funds to invest its assets in any securities other than affiliated funds, government securities, or short-term paper? If so, are there conditions we should include in

⁸² See 15 U.S.C. 80a-12(d)(1)(G)(i)(III). See also *supra* note 29.

⁸³ As noted above, we would expect directors to address the issue of duplicative fees in the exercise of their fiduciary duties. See *supra* notes 66-68, and accompanying text.

⁸⁴ Proposed rule 12d1-2(a)(3). See *supra* notes 35-57, 64-71 and accompanying text. A collateral effect of our rule proposals would be to permit an affiliated fund of funds to invest in an acquired fund that itself had a cash sweep arrangement. As discussed above, section 12(d)(1)(G) prohibits a fund from acquiring shares of another fund that does not have an investment policy prohibiting it from investing in shares of funds in reliance on section 12(d)(1)(F) or (G). An acquired fund investing in a money market fund under a cash sweep arrangement permitted under proposed rule 12d1-1 would not be relying on either of those sections. The fees and expenses of acquired funds would be aggregated and shown in the fee table in the acquiring fund's prospectus. See discussion below at section II.D of this Release.

the proposed rule to protect against the risks that underlie the section 12(d)(1)(G)(i)(III) limitations?

C. Rule 12d1-3: Unaffiliated Funds of Funds

Section 12(d)(1)(F) of the Act provides an exemption from section 12(d)(1)(A) that allows a registered fund to invest all its assets in other registered funds if: (i) the acquiring fund (together with its affiliates) acquires no more than 3 percent of any acquired fund; and (ii) the sales load charged on the acquiring fund's shares is no greater than 1½ percent.⁸⁵

Proposed rule 12d1-3 would permit funds relying on section 12(d)(1)(F) to charge sales loads greater than 1½ percent provided that the aggregate sales load any investor pays (*i.e.*, the combined distribution expenses of both the acquiring and acquired funds) does not exceed the limits on sales loads established by NASD for funds of funds.⁸⁶ The rule would codify a number of our exemptive orders.⁸⁷ Moreover, the limitations on distribution expenses reflect Congress's intent under NSMIA that the NASD regulate duplicative and excessive sales charges, as provided in section 12(d)(1)(G).⁸⁸ Our proposal would

⁸⁵ See 15 U.S.C. 80a-12(d)(1)(F)(i)-(ii). Section 12(d)(1)(F) also provides that the acquired fund is not obligated to redeem more than 1 percent of its outstanding securities held by the acquiring fund in any period of less than 30 days, and requires the acquiring fund to vote shares of an acquired fund either by seeking instructions from the acquired fund's shareholders or by voting in the same proportion as the other shareholders of the acquired fund. 15 U.S.C. 80a-12(d)(1)(F).

⁸⁶ See NASD Sales Charge Rule 2830(d)(3), *supra* note 29.

⁸⁷ The conditions in these orders limit aggregate sales charges to the limits imposed under the NASD Sales Charge Rule. See, e.g., Investec Ernst Company, Investment Company Act Release No. 25507 (Apr. 3, 2002) [67 FR 16775 (Apr. 8, 2002)] (notice), Investment Company Act Release No. 25552 (Apr. 24, 2002) (order); Lifetime Achievement Fund, Inc., Investment Company Act Release No. 24453 (May 12, 2000) [65 FR 31948 (May 19, 2000)] (notice), Investment Company Act Release No. 24489 (June 7, 2000) (order).

⁸⁸ See 15 U.S.C. 80a-12(d)(1)(G)(i)(III)(bb) (a fund relying on section 12(d)(1)(G) is limited from imposing sales loads and other distribution-related fees that, when aggregated with sales loads and distribution fees paid on acquired fund shares, are excessive under rules adopted under section 22(b) or 22(c) of the Act by a securities association registered under section 15A of the Securities Exchange Act or the Commission). In 1970, sales loads commonly were 8½ percent of the total payment, see Sen. Rep. No. 184, *supra* note 11, at 7, which would have resulted in an aggregate load of 10 percent of the total payment under the sales load limitation in section 12(d)(1)(F). The NASD Sales Charge Rule limits the aggregate sales loads on a fund of funds to 8½ percent if neither the acquiring fund nor the acquired fund in a fund of funds charges an asset-based sales charge, and to less than 8½ percent if they do. In addition, the

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⁷⁷ See H.R. Rep. No. 622, *supra* note 18, at 42.

⁷⁸ *Id.* at 43-44.

⁷⁹ Proposed rule 12d1-2(a)(2).

⁸⁰ Unlike section 12(d)(1)(G), section 12(d)(1)(F) does not restrict the other types of securities in which an unaffiliated fund of funds may invest.

⁸¹ See Van Kampen American Capital Comstock Fund, Inc., Investment Company Act Release No. 21977 (May 23, 1996) [61 FR 27118 (May 30, 1996)] (notice), Investment Company Act Release No. 22025 (June 18, 1996) (order). See also Smith Breeden Trust, Investment Company Act Release No. 23918 (July 21, 1999) [64 FR 40923 (July 28, 1999)] (notice), Investment Company Act Release No. 23947 (Aug. 17, 1999) (order) (permitting funds to acquire shares of another fund in the same group of investment companies that invests primarily in mortgage-backed securities issued by the U.S. government, its agencies, and instrumentalities).