

provide funds greater flexibility in structuring sales loads, consistent with the approach Congress took in section 12(d)(1)(G) to prevent excessive sales loads in affiliated funds of funds, while providing shareholders greater protection by requiring that funds relying on the rule limit overall distribution fees (rather than only sales loads). We seek comment on the proposed rule. Are there reasons to retain the 1½ percent sales load limit under an unaffiliated fund of funds arrangement rather than limit sales loads and distribution fees in conformance with section 12(d)(1)(G)(i)(III) limits for affiliated funds of funds?

D. Amendments to Forms N-1A, N-2, N-3, N-4, and N-6

We also are proposing amendments to Forms N-1A, N-2, N-3, N-4, and N-6 that would require that investors in a registered fund of funds receive better disclosure of the costs of investing in these arrangements. The proposed disclosure is designed to help investors understand the full costs of investing in a fund of funds, both to assist them in comparing the costs of investing in alternative funds of funds and in comparing the cost of an investment in a fund of funds with the cost of a more traditional fund.⁸⁹

Our current disclosure rules do not require funds (other than feeder funds) to provide information about the cost associated with investments in acquired funds.⁹⁰ Some funds of funds disclose expenses of acquired funds as an item of the acquired fund's annual operating expenses.⁹¹ Other funds list the

operating expense ratios of each acquired fund, without relating those costs to the acquiring fund's expenses.⁹² Still other funds merely note that the shareholder will indirectly bear a proportionate share of fees and expenses charged by acquired funds. In some cases, funds of funds provide no information regarding acquired funds' expenses. As a result, investors cannot always appreciate the total costs of investing in a fund of funds. Currently they have no direct means to determine whether the indirect costs of acquired funds will result in a higher overall cost of investing in a fund of funds when compared with another fund of funds, or a more traditional fund.

Under the proposed amendments to Form N-1A, any registered open-end fund investing in shares of another fund would be required to include in the fee table in its prospectus an additional line item under the section that discloses annual operating expenses.⁹³ The line item would set forth the acquiring fund's pro rata portion of the cumulative expenses charged by funds in which the acquiring fund invests. Those costs would be included in the acquiring funds' total annual operating expenses, which would be reflected in the "Example" portion of the fee table.⁹⁴ We seek comment on the proposed disclosure. Will the additional disclosure provide helpful information to investors? Is there a more informative means of providing investors information about the costs of acquired funds? Should the subcaption be included in Form N-1A with an instruction that it may be omitted for funds that do not invest in other funds?

We also are proposing instructions to the fee table to assist an acquiring fund in determining the amount of fees and expenses associated with acquired funds that must be reflected in the acquiring fund's fee table. The instructions would reflect expenses associated with the historical holdings in each acquired fund. The calculation would require the acquiring fund to aggregate the operating expenses of acquired funds and transaction costs and express them as a percentage of average net assets of the acquiring

fund.⁹⁵ Under this approach, the acquiring fund would calculate the average invested balance and number of actual days invested in each acquired fund.⁹⁶ We ask for comment on these instructions. Are they consistent with the current fee table? Is there another way to determine acquired funds' fees and expenses that would provide better disclosure of these costs? ⁹⁷ The instructions require the calculation of an average invested balance, which is based on a monthly average.⁹⁸ Should the average be calculated on a more frequent basis?

Expenses of the acquiring fund would be based on actual expenses or those reported in the most recent communication from the acquired fund.⁹⁹ Expenses of an acquired fund that is part of the same group of investment companies should reflect actual expenses of the fund. Expenses of other funds may be based on annual expenses reported in the most recent report or other communication received by the fund of funds.¹⁰⁰ If the acquiring fund paid any sales load to acquire shares of a fund during the past fiscal year, it must include that amount in its

⁹⁵ This approach is consistent with the current requirement that a feeder fund disclose the aggregate expenses of the feeder fund and master fund. See *supra* note 90.

⁹⁶ See proposed instruction 3(f)(ii) to Item 3, Form N-1A (to calculate the pro rata share of total operating expenses for each acquired fund, an acquiring fund would divide the acquired fund's total operating expense ratio by 365 days, and multiply the result by the average daily balance invested in the acquired fund and the number of days invested in the acquired fund).

⁹⁷ For example, the instructions could require an acquiring fund to take the amounts invested in each acquired fund as of a current measurement date and multiply those amounts by the corresponding total annual fund operating expense ratio for the acquired fund. This would require a fairly simple calculation based on investments on a single day that would reflect the acquired fund's asset size on the measurement date, rather than the actual results that are indirectly included in the acquiring fund's operations. Because it would be based on the most recent allocation of fund assets, this method may also disclose the expenses an investor is more likely to pay. The proposed instructions, however, are less likely to result in an understatement or overstatement of actual expenses paid by the acquiring fund.

⁹⁸ See proposed instruction 3(f) to Item 3, Form N-1A.

⁹⁹ The operating expenses for acquired funds are likely to be for a different period than that of the acquiring fund's fiscal year. If the acquiring and acquired funds are not part of the same fund complex, the acquiring fund would rely on operating expenses the acquired fund has disclosed in its most recent semi-annual report. Those expenses would be for a period that ended before publication of the report, and thus was before the acquiring fund's most recent fiscal year. If the acquiring and acquired funds are part of the same fund complex, the two funds may still have different fiscal years.

¹⁰⁰ See proposed instruction 3(f)(iv) to Item 3, Form N-1A.

NASD Sales Charge Rule limits aggregate asset-based sales charges the funds may impose. See *supra* note 29.

⁸⁹ A fund of funds may have higher fees and expenses than a fund that invests directly in debt and equity securities. See John Shipman, *Diversifying Through Funds of Funds—Small Investors Get Exposure to a Variety of Categories, But Fees, Overlap Are Issues*, Wall St. J., Nov. 7, 2002, at D11 ("[a]t least half of the funds of funds available to investors charge fees—amounting to more than 2% of assets in some cases—on the underlying portfolio, in addition to the costs of the underlying portfolios."); Yuka Hayashi, *Schwab Abandons "Fund of Funds"—High Fees Were Obstacle to Drawing Investors; New Managers to Step In*, Wall St. J., June 17, 2002, at C17 ("[t]he biggest problem was the high fees that Schwab had to charge in order to cover its own asset-management costs, as well as those of underlying funds.* * *").

⁹⁰ A feeder fund must disclose in its fee table the aggregate expenses of the feeder fund and master fund. See Instruction 1(d)(i) to Item 3, Form N-1A. For a description of feeder funds, see text accompanying note 18, *supra*.

⁹¹ See, e.g., GE Lifestyle Funds, Prospectus 10 (January 27, 2003), available at <http://www.sec.gov/Archives/edgar/data/1018218/000091205702002852/0000912057-02-002852-index.htm>.

⁹² Some of these funds note that expenses will differ depending on the acquiring fund's asset allocation in the acquired funds.

⁹³ The item would appear directly above the line item titled "Total Annual Fund Operating Expenses."

⁹⁴ The fee table example requires the fund to disclose the cumulative amount of fund expenses of 1, 3, 5, and 10 years based on a hypothetical investment of \$10,000 and an annual 5% return. See Item 3, Form N-1A.