

fee table (even if it no longer holds shares of that fund).¹⁰¹

The proposed disclosure requirements also would apply with respect to investments in any unregistered fund that would be an investment company under section 3(a) of the Act but for the exceptions provided in sections 3(c)(1) and 3(c)(7) of the Act.¹⁰² We do not see any reason to treat fund investments in these unregistered funds differently from investments in registered funds. Thus, a fund with a cash sweep arrangement could not avoid reporting the unregistered money market fund's expenses merely because the fund was not registered under the Act. Is there a basis for treating disclosure of unregistered and registered fund expenses differently?

Because we also are proposing to amend Form N-2, a registered closed-end fund of hedge funds would be required to include a pro rata portion of the hedge funds' expenses in its fee table.¹⁰³ In the case of a newly offered fund, including a newly offered fund of hedge funds, the fee table would reflect expenses the fund expects to incur based on its initial investments.¹⁰⁴ This approach is similar to that required of new funds.¹⁰⁵ We seek comment on the proposed amendments to Form N-2. In addition to the proposed instructions,

¹⁰¹ See proposed instruction 3(f)(ii) to Item 3 ("transaction fees" included in the calculation for acquired funds' fees and expenses include the total amount of sales loads, redemption fees, or other transaction fees paid by the acquiring fund in connection with acquiring shares in acquired funds during the year).

¹⁰² See proposed instruction 3(f)(1) to Item 3. See also 15 U.S.C. 80a-3(c)(1), 80a-3(c)(7), and *supra* note 50. High fees also are a concern with funds of hedge funds. See NASD Investor Alert, Funds of Hedge Funds—Higher Costs and Risks for Higher Potential Returns (Aug. 23, 2002) (available at: http://www.nasd.com/Investor/alerts/alert_hedgefunds.htm) ("Expenses in funds of hedge funds are significantly higher than most mutual funds."); Stephen J. Brown, William N. Goetzmann, and Bing Lang, Fees on Fees in Funds of Funds 18 (National Bureau of Econ. Research Working Paper No. 9464, 2003) ("The chief disadvantage of [funds of hedge funds] is the high fees that are typically charged * * *"). See also Daniel Kadlac, *Affordable Hedge Funds*, Time.com, <http://www.time.com/globalbusiness/html> ("The big drawback [of a fund of hedge funds] is that you pay two layers of fees: one to the fund-of-funds manager, who in turn gets charged by each fund in the portfolio.").

¹⁰³ See proposed instruction 10 to Item 3, Form N-2.

¹⁰⁴ See proposed instruction 3(f)(vi) to Item 3, Form N-1A. See also instruction 6 to Item 3, Form N-2.

¹⁰⁵ See Instruction 5(a) to Item 3, Form N-1A (new funds are instructed to base percentages to be included in the "Annual Fund Operating Expense" portion of the fee table on amounts that will be incurred (without reduction for expense reimbursement or fee waiver arrangements), estimating amounts of "Other Expenses").

are there additional matters our instructions should cover?

Our proposal also would require separate accounts to include in their registration forms, disclosures regarding the expenses of acquired funds. The proposal includes amendments to Forms N-3, N-4, and N-6.¹⁰⁶ We seek comment on the amendments to these forms. Are the different instructions appropriate to the respective forms?¹⁰⁷

III. General Request for Comments

We request comment on the proposed rules and form amendments that are the subject of this release, suggestions for additional provisions or changes to the rules and form amendments, and comments on other matters that might have an effect on the proposals contained in this release. We encourage commenters to provide data to support their views.

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,¹⁰⁸ we also request information regarding the potential effect of the proposals on the U.S. economy on an annual basis. Commenters are requested to provide empirical data to support their views. The Commission strives to draft its rules according to principles outlined in its Plain English Handbook.¹⁰⁹ We invite your comments on how to make the proposed rules and form amendments more consistent with those principles and easier to understand.

IV. Cost-Benefit Analysis

We are sensitive to the costs and benefits imposed by our rules. The proposed rules would provide relief to investment companies by providing additional exemptions from the limitations on fund of fund arrangements without requiring the funds to obtain an exemptive order. The proposed amendments to Forms N-1A, N-2, N-3, N-4, and N-6 would provide

¹⁰⁶ The proposed instructions to Form N-3 would require the same disclosure and calculation as required in the proposed instructions to Forms N-1A and N-2. The proposed instructions for Forms N-4 and N-6 are different, however, because those forms already require registrants to disclose expenses of funds ("portfolio companies") in which the separate account invests. See Item 3, Form N-4, Item 3, Form N-6. Accordingly, the proposed instructions to Forms N-4 and N-6 require that if a portfolio company invests in other funds, the registrant must include in the item disclosing the portfolio company's "other expenses," the Acquired Fund's fees and expenses calculated according to the proposed instructions to Form N-1A.

¹⁰⁷ See *supra* note 106.

¹⁰⁸ Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

¹⁰⁹ Office of Investor Education and Assistance, U.S. Securities and Exchange Commission, A Plain English Handbook (1998) (available on the Commission's Web site at <http://www.sec.gov>).

additional information to shareholders regarding the costs of acquired funds in a fund of funds arrangement. We have identified costs and benefits that may result from the proposed rules and form amendments, as described below.

A. Background on Proposed Rules 12d1-1, 12d1-2, and 12d1-3

Under current law, a fund is limited in the amount of securities it can acquire from another fund. In general under the Act, a registered fund (and companies it controls) cannot:

- Acquire more than three percent of another fund's securities;
- Invest more than five percent of its own assets in another fund; or
- Invest more than ten percent of its own assets in other funds in the aggregate.¹¹⁰

In addition, a registered open-end fund, its principal underwriter, and any registered broker or dealer cannot sell the fund's shares to another fund if, as a result:

- The acquiring fund (and any companies it controls) owns more than three percent of the acquired fund's stock; or
- All acquiring funds (and companies they control) in the aggregate own more than ten percent of the acquired fund's stock.¹¹¹

The Act provides three exceptions from these limitations that permit certain fund of funds arrangements. First, section 12(d)(1)(E) permits a fund to invest all its assets in *one* other fund, provided that (i) the depositor or principal underwriter for the fund is a registered broker or dealer (or a person it controls), and (ii) the acquiring fund is subject to certain voting restrictions on the shares of acquired funds.¹¹² Second, under section 12(d)(1)(F), a registered fund may invest any amount of its assets in other funds, provided that the acquiring fund (together with its affiliates) acquires no more than three percent of the securities of any other fund.¹¹³ These unaffiliated funds of funds are limited to charging a 1½ percent sales load on their shares and are subject to voting restrictions

¹¹⁰ See 15 U.S.C. 80a-12(d)(1)(A). If an acquiring fund is not registered, these limitations apply only with respect to the acquiring fund's acquisition of registered funds.

¹¹¹ See 15 U.S.C. 80a-12(d)(1)(B).

¹¹² See 15 U.S.C. 80a-12(d)(1)(E). The acquiring fund must either seek instruction from its shareholders with regard to voting all proxies with respect to the acquired fund's securities or vote the acquired fund shares in the same proportion as the vote of all other shareholders. In addition, in the event the acquiring fund is not registered, it cannot substitute the acquired fund shares without Commission approval.

¹¹³ See 15 U.S.C. 80a-12(d)(1)(F)(i).