

open-end fund that invests in other funds to include a line item in its fee table, under the fund's annual operating expenses, that lists the aggregate fees and costs of acquired funds. The proposed amendment to Form N-2 would require registered closed-end funds that invest in other funds to provide the same disclosure. The proposed amendment to Form N-3 would require the same disclosure for separate accounts organized as management investment companies that offer variable annuity contracts. The proposal includes instructions on calculating the fees and operating costs of acquired funds. The calculation would aggregate indirect operating expenses of acquired funds and transaction costs and express them as a percentage of average net assets of the acquiring fund.

Forms N-4 and N-6 currently require separate accounts organized as UITs that offer variable annuity and variable life contracts, respectively, to disclose the range of minimum and maximum operating expenses of the portfolio companies in which they invest. The proposed amendment to each of these forms would require a separate account organized as a UIT that invests in a portfolio company that itself invests in other funds, to include the portfolio company's costs of investing in other funds in the portfolio company's operating expenses disclosed in the N-4 or N-6 fee table.

1. Benefits

Under current disclosure requirements, a fund's shareholders may not understand the fees and operating costs of a fund's investment in acquired funds, costs that investors bear indirectly. We believe that the proposed amendments to Forms N-1A, N-2, N-3, N-4, and N-6 would enable shareholders to better understand the expenses that relate to acquired funds, and provide investors the means to compare directly the costs of investing in alternative funds of funds, or the costs of investing in a fund of funds to a more traditional fund. The increased transparency may provide further benefits by allowing investors to choose funds that more closely reflect their preferences for fees and performance. We have no means by which to quantify these benefits, however. We seek comment on the benefits of the proposed amendments (and any alternatives suggested by commenters) as well as any data quantifying those benefits.

2. Costs

The proposed amendments to Forms N-1A, N-2, N-3, N-4, and N-6 would result in costs to registered open-end and closed-end funds, and to separate accounts that offer variable annuity and variable life contracts, which may be passed on to those funds' shareholders. The proposal would require a new disclosure to the annual operating expense item in the fee table for funds that invest in other funds. It also would require separate accounts organized as UITs that offer variable annuity and variable life contracts to include an additional expense in its calculation of annual portfolio company operating expenses. The costs of the proposed disclosures would include both internal costs (for attorneys and accountants) to prepare and review the disclosure, and external costs (for printing and typesetting the disclosure).

First, with respect to Forms N-1A, N-2, and N-3, the proposed disclosures would add a single line item to the fee table for funds that invest in other funds. In the context of the prospectus, we believe that the external costs of including this additional line of disclosure per registered fund would be minimal. With respect to Forms N-4 and N-6, the proposal would require registrants to include in the item for annual portfolio company operating expenses, any fees and expenses of acquired companies, as disclosed in the portfolio company's most recent prospectus.

Second, for purposes of the Paperwork Reduction Act, Commission staff has estimated that the disclosure requirement for calculating the line item according to the proposed instructions would add up to 7 hours to the burden of completing Forms N-1A, N-2, and N-3. Thus, we estimate that the additional annual cost of including the line item per portfolio would equal \$410.¹²⁷ Commission staff also has estimated that including the additional item in the disclosure of portfolio company expenses on Forms N-4 and N-6 would add approximately 0.5 hours per portfolio, for an annual cost per portfolio of \$15.¹²⁸ Commission staff estimates that there are 224 fund of

funds portfolios.¹²⁹ Accordingly, we estimate that, at a minimum, the total annual internal costs of complying with the proposed form amendments would equal \$92,000.¹³⁰ In addition, Commission staff estimates that half the funds registered under Forms N-1A and N-2 invest in other funds, and 5 separate accounts (with 7 portfolios) registered under Form N-3 invest in other funds and would be required to make the proposed disclosure on an annual basis.¹³¹ For purposes of the Paperwork Reduction Act analysis, Commission staff has estimated that on an annual basis, registrants file (i) initial registration statements covering 483 portfolios and post effective amendments covering 6,542 portfolios on Form N-1A, (ii) 234 initial registration statements and 38 post-effective amendments on Form N-2, and (iii) initial registration statements covering 12 portfolios and post-effective amendments covering 152 portfolios on Form N-3. In addition, Commission staff also estimates that each year, 157 separate accounts file initial registrations and 1,242 separate accounts file post-effective amendments on Form N-4, and 50 separate accounts file initial registrations and 500 separate accounts file post-effective amendments on Form N-6.¹³² Of the filings on Forms N-4 and N-6, Commission staff estimates that half the separate accounts invest in portfolio companies that themselves invest in other funds. Thus, Commission staff estimates that the cost of the proposed amendments to Forms N-1A, N-2, N-3, N-4, and N-6 using the calculation in the proposed instructions would be \$1.5 million.¹³³

We do not know the number of funds that would be likely to begin investing in other funds under the proposed rules.

¹²⁹ The estimate of fund of funds portfolios is based on information gathered from Morningstar, Inc.

¹³⁰ The estimate is based on the following calculation: $224 \text{ portfolios} \times \$410 = \$91,840$.

¹³¹ See *infra* notes 139, 145, 151, and accompanying text.

¹³² Of these post-effective amendments, 150 are updates and 350 are additional post-effective amendments. Separate accounts file initial post-effective amendments to update their financial statements and provide any other material updates. The additional post-effective amendments generally are filed pursuant to Securities Act rule 485(b) to make non-material changes to the registration statement and are generally more limited and much simpler to prepare than post-effective amendments filed as annual updates. We assume that registered funds would include the proposed disclosure only in a post-effective amendment for the annual update.

¹³³ The estimate is based on the following calculation: $((483 + 6,542/2) \times \$410) + ((234 + 38/2 \times \$410) + (7 \text{ separate account portfolios} \times \$410) + ((157 + 1,242/2) \times \$15) + (200 \text{ separate accounts}/2 \times \$15) = \$1,510,747.5$.

¹²⁷ Commission staff estimated the cost to equal six hours for an intermediate-level accountant at \$30 per hour to perform the calculation and one hour for a deputy general counsel at \$230 per hour to review the calculation $(6 \times \$30) + (1 \times \$230) = \$410$.

¹²⁸ Commission staff estimated the cost to equal one-half hour for an intermediate level accountant to include the expense item in the calculation. The estimated cost is based on the following calculation: $0.5 \times \$30 = \15 .