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VI. Consideration of Promotion of Efficiency, Competition and Capital Formation

Section 2(c) of the Investment Company Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation.¹⁶²

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

Proposed rules 12d1-1, 12d1-2, and 12d1-3 will expand the circumstances in which funds can invest in other funds without first obtaining an exemptive order from the Commission, which can be costly and time-consuming. We anticipate that the proposed rules will promote efficiency and competition. Proposed rule 12d1-1 would permit funds to acquire shares of money market funds in the same or in a different fund group in excess of the limitations in section 12(d)(1). This exemption should allow funds, particularly small funds without a money market fund in their complex, to allocate their uninvested cash more efficiently and thereby increase competition among funds. Proposed rule 12d1-2 would permit an affiliated fund of funds to acquire limited amounts of securities issued by funds outside the same fund group and securities not issued by a fund, as well as permit a traditional equity or bond fund to invest in funds within the same fund complex. We believe that this expansion of investment opportunities also will permit funds to allocate their investments more efficiently. The effects of the proposed rules on capital formation are unclear.

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

The proposed form amendments are intended to provide better transparency for fund shareholders with respect to the costs of investing in funds of funds. The enhanced disclosure requirements would provide shareholders with greater access to information regarding the indirect costs they bear when a fund in which they invest purchases shares of other funds. This information should promote more efficient allocation of investments by investors and more efficient allocation of assets among

competing funds because investors may compare and choose funds based on their preferences for cost more easily. The proposed amendments may also improve competition, as enhanced disclosure may prompt funds to provide improved products and services that may have a greater appeal to better-informed investors. Enhanced disclosure also may prompt acquiring funds to invest in acquired funds with lower costs. Finally, the effects of the proposed amendments on capital formation are unclear. Although, as noted above, we believe that the proposed amendments would benefit investors, the magnitude of the effect of the proposed amendments on efficiency, competition, and capital formation is difficult to quantify, particularly given that most funds do not currently provide the type of disclosure contemplated by the proposed amendments.

C. Request for Comment

We request comment on whether the proposed rules and form amendments, if adopted, would promote efficiency, competition, and capital formation. We also request comment on whether the proposed rules and form amendments, if adopted, would impose a burden on competition. Commenters are requested to provide empirical data and other factual support for their views, if possible.

VII. Summary of Initial Regulatory Flexibility Analysis

We have prepared an Initial Regulatory Flexibility Analysis ("IRFA") under 5 U.S.C. 603 regarding proposed rules 12d1-1, 12d1-2, and 12d1-3, and proposed amendments to Forms N-1A, N-2, N-3, N-4, and N-6 under the Investment Company Act. The following summarizes the IRFA. The IRFA summarizes the reasons, objectives, and legal basis for the proposed rules and form amendments. The IRFA also discusses the effect of the proposed rules and form amendments on small entities. The staff estimates, based upon Commission filings, that there are approximately 5,025 active registered funds and 48 business development companies, of which approximately 209 and 28 are small entities, respectively.¹⁶³ The staff

estimates that few, if any, registered separate accounts are small entities. Funds that are small entities, like other funds, may rely on the proposed rules if they satisfy the conditions. Under the proposed form amendments, a fund that invests in another fund would be required to disclose the aggregate expenses of acquired funds.

We believe that the proposed rules would have little impact on small entities. Like other funds, small entities would be affected by the proposed rules only if they determined to use the exemptions provided under the proposed rules. Few small entities have applied for relief to engage in the activities that would be permitted under the proposed rules.¹⁶⁴ The proposed amendments to Forms N-1A and N-2 would likely have a greater impact on small entities.

As noted above, compliance with the proposed rules is voluntary, and therefore the proposed rules would not impose mandatory reporting or recordkeeping requirements and would not materially increase other compliance requirements. No federal rules duplicate or conflict with the proposed rules. The Commission is seeking comment on the proposed amendments to Forms N-1A, N-2, N-3, N-4, and N-6. Commission staff has estimated that the burden per small fund portfolio would be up to 7 hours, at a cost of \$410.¹⁶⁵ Assuming half of small funds invest in other funds and were required to comply with the form amendments, we estimate the annual disclosure cost for small entities would be \$93,685.¹⁶⁶

We have considered significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. We considered: (a) Differing compliance or reporting requirements or

¹⁶⁴ If the rules were adopted more small entities may use the relief provided, but the number of small entities engaging in these activities would probably remain small.

¹⁶⁵ If each portfolio of a registered fund includes the proposed disclosure, staff estimates the disclosure required by the proposed instructions would take up to 6 hours for an intermediate accountant at a rate of \$30 per hour plus one hour for a deputy general counsel at a rate of \$230 per hour to perform $((6 \times \$30) + (1 \times \$230) = \$410)$. See Securities Industry Association, *Report on Management and Professional Earnings in the Securities Industry* (2002).

¹⁶⁶ There are 157 small funds registered under Form N-1A, with an average of 2.7 portfolios per registrant. There are 33 small funds registered under Form N-2, with an average of 1 portfolio per registrant. Thus, Commission staff estimates there are a total of 457 portfolios $((157 \times 2.7) + 33 = (423.9 + 33) = 456.9)$ reporting under Forms N-1A and N-2. The estimate of annual disclosure cost is based on the following calculation: $457/2 \text{ portfolios} \times \$410 = \$93,685$.

¹⁶² 15 U.S.C. 80a-2(c).

¹⁶³ For purposes of the Regulatory Flexibility Act, a fund is a small entity if the fund, together with other funds in the same group of related funds, has net assets of \$50 million or less as of the end of its most recent fiscal year. Rule 0-10 [17 CFR 270.0-10]. The number of small entities is derived from analyzing information from databases such as Morningstar, Inc. and Lipper. Some or all of these entities may contain multiple series or portfolios, which are also small entities.