

July 17, 2006

SEC Adopts New Rules Allowing Funds to Invest in Other Funds

On June 20, 2006, the U.S. Securities and Exchange Commission adopted three new rules under the Investment Company Act of 1940 ("1940 Act") as well as several related amendments to investment company registration statement forms. The new rules represent a significant liberalization of the restrictions found in Section 12(d) of the 1940 Act applicable to investment companies. Section 12(d)(1)(A) prohibits registered funds from:

- acquiring more than 3% of another fund's voting securities;
- investing more than 5% of its total assets in a single fund; and
- investing more than 10% of its total assets in all funds.

Section 12(d)(1)(B) prohibits a registered open-end fund from selling its securities to another fund (including unregistered funds) if after the sale:

- the acquiring fund owns more than 3% of the selling fund; or
- the acquiring fund together with other funds own more than 10% of the selling fund's voting securities.

Pooled investment vehicles, such as hedge funds, relying on Section 3(c)(1) or Section 3(c)(7) of the 1940 Act to avoid investment company regulation are considered investment companies for the purposes of the 3% restrictions in both Section 12(d)(1)(A) and (B). Unregistered foreign funds are bound by all of the restrictions of Section 12(d)(1).

Money Market Funds and Cash Sweeps. New Rule 12d1-1 permits cash sweep arrangements by registered and unregistered investment companies with registered and unregistered money market funds that meet the SEC's requirements for a money market fund and are managed by a registered investment adviser without having to observe the 3%, 5% and 10% investment limitations. The rule also provides relief from certain provisions of Section 17 of the 1940 Act and the SEC's related rules for investments in money market funds that might otherwise create prohibited or regulated affiliate relationships. An affiliate arrangement, for instance, would arise when a fund acquires 5% or more of a money market fund, making the money market fund and its manager and distributing broker affiliates of the acquiring fund. As a condition, the rule requires that the acquiring fund pay no sales charge or service fee. Unregistered money market funds are covered by the rule to the extent they invest and operate under many of the restrictions imposed on registered money market funds.

Affiliated Fund of Funds. New Rule 12d1-2 provides greater flexibility for affiliated fund of funds investments. Section 12(d)(1)(G) permits a registered open-end fund to invest an unlimited amount in other registered open-end funds and unit investment trusts in the same group of investment companies. The new rule now permits, subject to various conditions, a registered fund relying on Section 12(d)(1)(G) to invest in (i) up to 3% of an unaffiliated fund's voting securities, (ii) stocks, bonds and other securities not issued by a fund, and (iii) affiliated and unaffiliated money market funds in reliance on Rule 12d1-1.

Unaffiliated Fund of Funds. New Rule 12d1-3 allows an unaffiliated registered fund greater flexibility in structuring the sales load it charges. Section 12(d)(1)(F) only allows the acquiring fund of unaffiliated funds to charge sales loads no greater than 1½%. The new rule now allows funds that acquired no more than 3% of a selling fund's securities to charge an aggregate

sales load (i.e., the combined distribution expenses of both the acquiring and acquired funds) that is no greater than the limits on sales loads established by the NASD for funds of funds. NASD Sales Charge Rule 2830(d)(3).

The SEC also adopted amendments to registered fund disclosure requirements to provide greater transparency of fund of funds expense and fee layering. The amendments affect the fee table presentations in Forms N-1A, N-2, N-3, N-4 and N-6.

Rules 12d1-1, 12d1-2 and 12d1-3 become effective on July 31, 2006. The form amendments apply to filings on or after January 2, 2007.

We Can Help

Katten Muchin Rosenman LLP has extensive experience in dealing with all aspects of investment company registration and regulation. We will be happy to discuss with you the issues raised by the new rules and form amendments and their implications for your business. Please contact one of the following Katten Muchin Rosenman LLP attorneys:

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Note: This Client Advisory is a follow-up to the report in our Corporate and Financial Weekly Digest of June 23, 2006.

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