



Acquired Fund Fee Expenses and Business Development Companies

Background

The requirement of the Securities and Exchange Commission (the “SEC”) for registered open-end funds to disclose “acquired fund fees and expenses” (“AFFE”) of other funds they invest in, including business development companies (“BDCs”), is useful to revisit at this time in light of the recent release of the U.S. Department of Labor’s final fiduciary rule (the “DOL final rule”). The DOL final rule, among other things, prohibits a fiduciary providing investment advice to a plan subject to the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), from causing the fiduciary or any of its affiliates to receive commission or transaction-based compensation unless there is an available exemption. Investments in BDCs are not a restricted asset class under the DOL final rule, and one available exemption is the “best interest contract exemption” (“BICE”). However, the requirements of the BICE limit its practical benefit for investments in BDCs and will likely result in ERISA plans avoiding such investments, whether directly or indirectly through an index.¹ This in turn will further reduce the level of institutional ownership in BDCs. The decline of institutional ownership in BDCs, which has contributed to the volatility of BDC stocks, can be traced to the establishment of the AFFE requirement (which we describe in more detail below) and was further exacerbated by the removal of BDCs from the Russell 2000 Index in March 2014.

AFFE Requirement

In June 2006, the SEC adopted amendments to Form N-1A to require any registered open-end fund investing in shares of another fund, including BDCs, to include in its prospectus fee table an additional line item titled “Acquired Fund Fees and Expenses.”² Under amended Item 3 of Form N-1A, an acquiring fund must aggregate the amount of total annual fund operating expenses of acquired funds (which are indirectly paid by the acquiring fund) and transaction fees (which are directly paid by the acquiring fund over the past year) and express the total amount as a percentage of average net assets of the acquiring fund. The acquiring fund must determine the average invested balance and number of actual days invested in each acquired fund. The acquiring fund also must include in the expense calculation any transaction fee the acquiring fund paid to acquire or dispose of shares of an acquired fund during the past fiscal year (even if it no longer holds shares of the acquired fund).

¹ For more information regarding the DOL final rule and the BICE, see our client alert titled “Impact of DOL’s Final Rule on Business Development Companies” (August 1, 2016), available at: <http://www.mofo.com/~media/Files/ClientAlert/2016/08/160801PracticalImpactDOLRule.pdf>.

² See Fund of Funds Investments, Investment Company Act Release No. 27399 (June 20, 2006) (“Fund of Funds Investments Release”), available at: <http://www.sec.gov/rules/final/2006/33-8713.pdf>.

SEC Q&As

In June 2007, the staff (the “Staff”) of the SEC’s Division of Investment Management provided guidance, in the form of responses to questions (the “Q&As”), on the AFFE disclosure requirement.³ Although Q&As specifically refer to Item 3 of Form N-1A, the Staff indicated that the responses apply equally to similar items in Form N-2 and Form N-3. Highlights of the Q&As include the following:

- AFFE is intended to include the expenses of investments in investment companies, hedge funds, private equity funds, and other entities traditionally considered pooled investment vehicles. Therefore, the Staff would not recommend enforcement action if an acquiring fund does not include in the fee table expenses associated with investments in structured finance vehicles, collateralized debt obligations, or other entities not traditionally considered pooled investment vehicles.
- Instruction 3(f)(iv) to Item 3 of Form N-1A provides that the total annual operating expense ratio used for purposes of calculating AFFE is the annualized expense ratio disclosed in the acquired fund’s most recent shareholder report. This expense ratio does not include expenses an acquired fund has incurred through its investment in other companies.
- Open-end feeder funds filing on Form N-1A must disclose in their fee tables the aggregate expenses of the feeder fund and the master fund.
- The term “most recent” refers to the acquired fund’s shareholder report available at the time the acquiring fund calculates the AFFE. The acquiring fund should use the acquired fund’s required expense ratio presented in the financial highlights table contained in the most recent annual or semi-annual report when the acquiring fund calculates the AFFE. However, if the semi-annual report is the most recent report, the acquiring fund must use an annualized expense ratio.
- For the AFFE formula, weekend days should be included in the calculation of the daily expense ratio and the number of days invested in an acquired fund. However, weekend days should not be included in the calculation of the average invested balance.
- The amounts invested in an acquired fund are calculated using the value of the investment in the acquired fund as of the measurement date, which would take into account market appreciation (except for money market investments priced at amortized cost). For example, if the acquiring fund calculates average daily investment in a registered open-end fund, the acquiring fund would base the value of that investment on the acquired fund’s net asset value (“NAV”) at the end of each day, which would include any unrealized appreciation or loss with respect to the acquiring fund’s investment.
- Fees and expenses associated with investment of cash collateral received in connection with loans of portfolio securities in a money market fund or other cash sweep vehicle that meets the definition of acquired fund do not have to be included in the calculation of AFFE.
- Any transaction fees paid in connection with acquiring or disposing of a debt interest in an acquired fund must be included in the calculation of AFFE but not its pro rata portion of the cumulative expenses charged by the acquired fund because these expenses do not impact its debt interest in the acquired fund.

Response of Industry Participants

Since the issuance of the Fund of Funds Investments Release, various industry participants have recommended that the SEC remove or amend the AFFE disclosure requirement with respect to BDCs for two main reasons. First, much like real estate investment trusts (“REITs”) and regional/commercial banks, BDCs are not passive investment companies and instead “operate” a portfolio of financial assets that requires sourcing and managerial

³ See SEC Staff Responses to Questions Regarding Disclosure of Fund of Funds Expenses (last modified May 23, 2007), available at: <https://www.sec.gov/divisions/investment/guidance/fundfundfaq.htm>.

expertise. Therefore, BDCs should not be treated as funds for purposes of the AFFE disclosure requirement, particularly when their impact on mutual funds and indexes is relatively small. For example, while the estimated impact of BDCs to the Russell 2000 Index was less than 0.10% in 2014, the estimated impact from REITs and regional/commercial banks was approximately 1.19% (= 11.80% average REIT costs as a percentage of equity multiplied by 10.11% equity REIT representation in the Russell 2000 Index) and 1.61% (= 24.30% average regional bank cost as a percentage of equity multiplied by 6.62% regional bank representation in the Russell 2000 Index), respectively. (Source: Bloomberg and Wells Fargo Securities, LLC) Second, the AFFE disclosure requirement results in overstated expense ratios because an acquiring fund's indirect expenses required to be included in the calculation of AFFE can often be significantly greater than the direct expenses and the expense ratios of BDCs can be extremely high. Furthermore, a BDC's expenses (1) are similar to the expenses paid by any operating company held by an acquiring fund, (2) are not direct costs paid by the acquiring fund's shareholders, (3) are not used to calculate the acquiring fund's NAV, (4) have no impact on the costs associated with the operations of the acquiring fund, and (5) are not included in the acquiring fund's financial statements, which provide a clearer picture of the acquiring fund's actual operating costs. At this time, it is not clear whether the SEC will take any action regarding the AFEE disclosure requirement with respect to BDCs.

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