

ACT ICA

SECTION 2(a)(32), 12(d)(1)(E), 17(a)

RULE _____

URLEO

AVAILABILITY 12/28/99

December 28, 1999
Our Ref. No. 99-825
Signature Financial
Group, Inc.
File No. 132-3

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Your letter of December 22, 1999 on behalf of Signature Financial Group, Inc. requests that the staff of the Division of Investment Management confirm that a registered open-end investment company's satisfaction of a redemption request from an affiliated person, whether or not itself a registered investment company, by means of an in-kind distribution of portfolio securities is not a "purchase" or "sale" for purposes of Section 17(a) of the Investment Company Act of 1940 (the "Investment Company Act"). For the reasons stated below, we decline to provide the requested confirmation. Nonetheless, we would not recommend enforcement action to the Commission under Section 17(a) of the Investment Company Act if, under the circumstances described below and without obtaining an order from the Commission under Section 17(b) of the Investment Company Act, a registered open-end investment company satisfies a redemption request from an affiliated person, whether or not itself a registered investment company, by means of an in-kind distribution of portfolio securities.

Facts

Your letter specifically addresses the legal status of redemptions in kind between investment companies operating in a master-feeder structure¹ in reliance on Section 12(d)(1)(E) of the Investment Company Act,² as well as redemptions in kind between a fund and other affiliated shareholders. You acknowledge that a redemption in kind involving an affiliated shareholder would be prohibited by

¹ You state that a master-feeder structure is a two-tiered structure in which one fund, a feeder fund, invests substantially all of its assets in another fund, a master fund. You state that the master fund typically is a registered investment company, and one or more of the feeder funds also may be registered investment companies. Some feeder funds, however, may be entities other than registered investment companies, including offshore and other institutional investors.

² Section 12(d)(1)(E) of the Investment Company Act generally permits an investment company to purchase or acquire the shares of another investment company so long as, among other things, those shares are the only investment securities owned by the acquiring investment company.

Section 17(a) of the Investment Company Act if it were viewed as a "purchase" or "sale" of securities or other property from or to a registered fund by an affiliated person. For a variety of reasons, however, you argue that redemptions in kind should not be regarded as purchases or sales for purposes of Section 17(a).

Among other things, you state that the only property that could be "sold" by an affiliated shareholder in a redemption in kind is the shareholder's interest in the fund. You assert that, even assuming that the transaction is a "sale," the redemption of the affiliated shareholder's interest is not an impermissible affiliated transaction: Section 17(a)(1)(A) of the Investment Company Act permits affiliated persons to "sell" to a fund securities issued by the fund. In addition, you assert that the Second Circuit's decision in SEC v. Sterling Precision Corporation is instructive in analyzing the status of redemptions in kind under the Investment Company Act.³ In Sterling, the court held that a cash redemption by an operating company of securities it issued that were owned by an affiliated registered fund did not constitute a purchase of the securities by the company for purposes of Section 17(a)(2) of the Investment Company Act.⁴ You acknowledge, however, that the court in Sterling did not reach the issue of whether a distribution of portfolio securities by a fund to an affiliated person as part of a redemption constitutes a purchase for purposes of Section 17(a)(2).

You also assert that various provisions of the Investment Company Act and other applicable law provide ample protections against potential abuses involved in the satisfaction of a redemption request by means of a distribution in kind of portfolio securities. You state that fund directors and investment advisers are subject to strict fiduciary duties under federal and state law and to specific requirements relating to valuation and redemptions, whether they are determining which securities to distribute in a redemption in kind, or determining which securities to liquidate to satisfy cash redemptions. As a result, you submit that the determination of the most appropriate means to effect a redemption in kind to an affiliated shareholder -- whether through a pro rata distribution⁵ or some other

³ 393 F.2d 214 (2d Cir. 1968) ("Sterling").

⁴ The operating company was an affiliated person of the registered fund because the fund owned more than 5% of the operating company's voting securities.

⁵ A pro rata distribution results in a shareholder receiving a proportionate share of every security position in a fund's portfolio.

procedure -- is best left to fund management, subject to its fiduciary duties, and after taking into account appropriate factors, such as liquidity requirements, diversification requirements, and the particular fund's investment objectives and restrictions.

You state that redemptions in kind can substantially benefit the redeeming and non-redeeming shareholders, and can be less burdensome to a fund than cash redemptions. You assert a fund's need to generate cash to satisfy a large redemption request may require the fund to promptly sell large amounts of portfolio securities and may disrupt management of the portfolio. You state that it may be easier -- or necessary under the circumstances -- for the fund to sell the most liquid securities in its portfolio even though the fund otherwise might wish to retain those securities as long-term investments. Such a sale, you assert, may leave the fund with a less liquid and more volatile portfolio, which may increase the difficulty of ongoing management and of meeting future redemption requests. Alternately, you state that the fund may sell less liquid securities, but the rapid sale of a large block of less liquid securities may cause the fund to receive lower prices than it might have obtained in a more orderly disposition. In addition, you note that transaction costs generally must be borne by all shareholders, including those that do not redeem.

You state that a redemption in kind, on the other hand, can allow a fund to honor a redemption request while avoiding the disruptions of portfolio management that may be caused by cash redemptions. A redemption in kind also may provide benefits to a redeeming shareholder without any detriment to the remaining shareholders. For example, you state that a redemption in kind may allow the redeeming shareholder to continue its investment program under different management or in a different vehicle without incurring significant transaction costs. In addition, you state that in-kind withdrawals from an investment company that is organized as a partnership may have significant tax advantages for the redeeming shareholder in some cases.⁶

⁶ You also state that a fund will be required to recognize any gain if it sells portfolio securities to satisfy a redemption request in cash, thus often causing all fund shareholders to realize taxable gain in connection with a redemption transaction. You state that, in contrast, a fund ordinarily will not recognize gain upon the distribution of its portfolio securities to a shareholder in satisfaction of a redemption request. Telephone conversation between Jeremy N. Rubenstein of Wilmer, Cutler & Pickering and David W. Grim of the staff on December 28, 1999.

Analysis

Section 17(a)(1) of the Investment Company Act prohibits any affiliated person, or any affiliated person of an affiliated person, of a registered investment company, acting as principal, from knowingly selling securities or other property to the investment company. Section 17(a)(1)(A) excludes from this prohibition any sale that involves solely securities of which the buyer is the issuer.⁷ Section 17(a)(2) of the Investment Company Act prohibits any affiliated person, or any affiliated person of an affiliated person, of a registered investment company, acting as principal, from knowingly purchasing securities or other property from the investment company (except securities of which the seller is the issuer).⁸ If a redemption in kind involving an affiliated shareholder is considered to be a "purchase" or "sale" of securities or other property from or to a registered fund by an affiliated person, it could be prohibited under Section 17(a) of the Investment Company Act.

⁷ Section 2(a)(34) of the Investment Company Act defines "sale" to include every contract of sale or disposition of a security, or interest in a security, for value.

⁸ Section 2(a)(3) of the Investment Company Act provides that:

[a]ffiliated person of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; ... [and] (E) if such other person is an investment company, any investment adviser thereof....

You state that, in a master-feeder structure, a feeder fund generally holds five percent or more of the outstanding voting interests of the master fund, and thus the feeder fund and the master fund may be deemed to be affiliated persons of each other pursuant to Sections 2(a)(3)(A) and (B) of the Investment Company Act. You also state that the master and feeder funds may be deemed to be affiliated persons for other reasons (e.g., pursuant to Section 2(a)(3)(C) by virtue of being under common control).

A redemption in kind from a registered master fund to a registered feeder fund involves separate transactions in which each fund may be viewed as an affiliated person that is subject to the prohibitions of Section 17(a). Specifically, those redemptions involve the following distinct transactions: (1) the feeder fund's redemption of its holdings of the master fund's shares, which may be viewed as a sale of securities by an affiliated person (the feeder fund) to a registered investment company (the master fund) under Section 17(a)(1) of the Investment Company Act; (2) the feeder fund's receipt of portfolio securities from the master fund, which may be viewed as a purchase of securities by an affiliated person (the feeder fund) from a registered investment company (the master fund) under Section 17(a)(2); (3) the master fund's distribution of portfolio securities to the feeder fund, which may be viewed as a sale of securities by an affiliated person (the master fund) to a registered investment company (the feeder fund) under Section 17(a)(1); and (4) the master fund's redemption of its shares, which may be viewed as a purchase of securities by an affiliated person (the master fund) from a registered investment company (the feeder fund) under Section 17(a)(2).⁹

Redemptions in Cash

We believe that the wording of Sections 2(a)(34) and 17(a)(1) of the Investment Company Act indicates that Congress considered "sale" to include all dispositions of securities for value, including a fund shareholder's transfer of fund shares to the fund as part of a redemption. We also believe that Congress created a very limited exception in subsection (A) of Section 17(a)(1) for cash redemptions to affiliated persons, in which the only securities involved in the sale are those of which the buyer (the fund) is the issuer.¹⁰ Thus, a registered fund's payment of a cash redemption to an affiliated shareholder that is not a registered fund is not prohibited by Section 17(a)(1) of the Investment Company Act.

⁹ A redemption in kind between a registered investment company and an affiliated shareholder that is not itself a registered investment company (including unregistered feeder funds) involves only transactions (1) and (2).

¹⁰ We note that it would not have been necessary for Congress to have created the exception in subsection (A) if it had not considered a redemption to involve a sale of securities.

We also believe that a registered fund's payment of a cash redemption to an affiliated shareholder that is not a registered fund is not a prohibited purchase under Section 17(a)(2) of the Investment Company Act. We believe that, although cash is property within the meaning of Section 17(a)(2), an affiliated shareholder that receives cash as part of a redemption is not "purchasing" that cash. We note that the exception in Section 17(a)(1)(A) for the sale of fund shares by an affiliated person back to the issuing fund would have little, if any, utility if the accompanying transfer of cash to the affiliated person was considered to be a purchase prohibited by Section 17(a)(2).

Additional issues are presented by a registered feeder fund's cash redemption from a registered master fund. In such a transaction, the master fund, as the affiliated person,¹¹ may be considered to be purchasing securities (master fund shares) from a registered investment company (the feeder fund). As stated above, Section 17(a)(2) generally prohibits an affiliated person from purchasing securities or other property from a registered investment company, but includes an exception for purchases of securities of which the seller is the issuer. The exception does not, however, apply to this purchase because the master fund shares are securities of which the buyer, not the seller, is the issuer. Therefore, a cash redemption by a feeder fund from a master fund could be viewed as triggering Section 17(a)(2).¹²

We believe, however, that the application of Section 17(a) of the Investment Company Act to a registered feeder fund's cash redemption from a registered master fund would not be consistent with the basic relationship that Section 12(d)(1)(E) of the Investment Company Act is intended to permit. In addition, we believe that this issue was

¹¹ As stated in footnote 8 *supra*, a feeder fund generally holds five percent or more of the outstanding voting interests of the master fund, and thus the feeder fund and the master fund may be deemed to be affiliated persons of each other pursuant to Sections 2(a)(3)(A) and (B) of the Investment Company Act.

¹² We recognize that the master fund, as the affiliated person, also could be viewed as selling cash to the registered feeder fund in violation of Section 17(a)(1) of the Investment Company Act. We believe, however, that an affiliated person that transfers cash as part of a redemption is not "selling" the cash for purposes of Section 17(a)(1), just as an affiliated shareholder that receives cash as part of a redemption is not "purchasing" that cash for purposes of Section 17(a)(2).

addressed generally by the Second Circuit's decision in Sterling, in which the court, as stated earlier, held that the cash redemption by an operating company of securities it issued that were owned by an affiliated fund did not constitute a purchase of the securities by the company under Section 17(a)(2) of the Investment Company Act. As a result, we believe that Section 17(a) does not prohibit a cash redemption by a feeder fund from a master fund.

Redemptions in Kind

While we believe that cash redemptions to affiliated shareholders do not trigger Section 17(a) of the Investment Company Act, we believe that redemptions in kind to affiliated shareholders are governed by this section. As stated above, Section 17(a)(1) makes it unlawful for an affiliated person "knowingly to sell any security or other property to such registered company, unless such sale involves solely (A) securities of which the buyer is the issuer (emphasis added)." We believe that the phrase "involves solely" in Section 17(a)(1)(A) means that the only security that can be involved in the transaction is the fund's shares. Thus, while the exception permits a cash redemption to an affiliated shareholder, in which the only securities involved in the sale are the fund's shares, we believe that the exception does not permit a redemption in kind to an affiliated shareholder, which involves fund portfolio securities as well as fund shares.

We believe that this interpretation of Section 17(a) of the Investment Company Act is consistent with the purpose underlying the section.¹³ Section 17(a) was designed primarily to prohibit "a purchase or sale transaction when a party to the transaction has both the ability and the pecuniary incentive to influence the actions of the investment company."¹⁴ In our view, redemptions in kind

¹³ We also believe that this interpretation of Section 17(a) is consistent with the Commission's interpretation of the section in connection with its adoption of Rule 17a-5 under the Investment Company Act. Rule 17a-5 provides that a pro rata distribution in kind among a fund's shareholders without giving any election to any shareholder as to the specific assets that the shareholder will receive does not involve a sale to or purchase from the fund for purposes of Section 17(a). We believe that the adoption of this rule would not have been necessary if the Commission did not view a distribution in kind as involving a sale and purchase under Section 17(a).

¹⁴ Investment Company Act Release No. 10886 (Oct. 2, 1979), citing Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on

provide greater opportunities for overreaching by affiliated persons than cash redemptions. For example, an investment adviser to a fund that seeks to receive a redemption in kind from the fund could use its influence to cause the fund to favor the adviser by distributing portfolio securities of limited availability or securities that it had undervalued. In addition, a large shareholder of a fund could threaten to redeem its entire investment in the fund unless it similarly received favorable treatment. Finally, in the context of a master-feeder fund, the master fund, as the affiliated person, could distribute to the registered feeder fund securities that the master fund had overvalued in an effort to favor the non-redeeming shareholders.¹⁵

Although we believe that redemptions in kind to affiliated shareholders trigger Section 17(a) of the Investment Company Act, we recognize that there are benefits to redemptions in kind, and that redemptions in kind involving affiliated persons can be effected fairly without implicating the concerns underlying Section 17(a) under certain circumstances. We note that the Division of Investment Management, pursuant to delegated authority from the Commission, has issued many exemptive orders permitting redemptions in kind to affiliated shareholders, subject to certain conditions designed to ensure that the redemptions in kind are consistent with the concerns underlying Section 17(a).¹⁶ We also note that funds, which generally are required by Section 22(e) of the Investment Company Act to satisfy redemption requests within seven days of the tender

Banking and Currency, 76th Cong., 3d Sess., at 256-59 (1940).

¹⁵ Of course, the incorrect valuation of a fund's portfolio securities could violate various provisions of the federal securities laws.

¹⁶ For example, a standard condition of the exemptive orders requires the redemption in kind to be pro rata, with adjustments for restricted securities, odd lots, fractional shares, etc. See SR&F Base Trust, Investment Company Act Release Nos. 23297 (July 1, 1998) (notice) and 23364 (July 28, 1998) (order) (condition 2). This condition is intended to ensure that there is no opportunity for overreaching, as it essentially eliminates the ability of any party to exercise any influence or control over the selection of the securities to be distributed. See Investment Company Act Release No. 2231 (Sept. 28, 1955) (release adopting Rule 17a-5 under the Investment Company Act) ("none of the abuses against which Section 17 of the [Investment Company] Act was directed are present in ... a pro rata distribution" within the scope of the rule).

of the shares, could not obtain an exemptive order to permit an affiliated shareholder to receive a redemption in kind within the seven-day period.

We believe that funds may make redemptions in kind to affiliated shareholders under certain circumstances that are consistent with the purpose of Section 17(a), without the need to obtain exemptive orders under Section 17(b). As a result, we would not recommend enforcement action under Section 17(a) of the Investment Company Act if a registered open-end investment company satisfies a redemption request from an affiliated person, whether or not itself a registered investment company, by means of an in-kind distribution of portfolio securities, provided that:

- 1) the redemption in kind is effected at approximately the affiliated shareholder's proportionate share of the distributing fund's current net assets, and thus does not result in the dilution of the interests of the remaining shareholders;¹⁷
- 2) the distributed securities are valued in the same manner as they are valued for purposes of computing the distributing fund's net asset value;¹⁸
- 3) the redemption in kind is consistent with the distributing fund's redemption policies and undertakings, as set forth in the fund's prospectus and statement of additional information;
- 4) neither the affiliated shareholder nor any other party with the ability and the pecuniary incentive to influence the redemption in kind selects, or influences the selection of, the distributed securities;¹⁹

¹⁷ See Section 2(a)(32) of the Investment Company Act.

¹⁸ See Rule 22c-1 under the Investment Company Act (generally requiring redemptions to occur at the net asset value next determined after the redemption order is received); Rule 2a-4 under the Investment Company Act (generally requiring the current net asset value for purposes of redemption to be computed according to specified requirements, including the use of current market value for all portfolio securities for which market quotations are readily available, and of fair value as determined in good faith by the board of directors for all other assets).

¹⁹ We recognize that it may be appropriate for the adviser, subject to its fiduciary duty to the fund, to be involved in the selection of the securities to be distributed under many circumstances. We believe, however, that the potential for overreaching may be substantial when

5) (A) the redemption in kind is approved by the distributing fund's board of directors, including a majority of the directors who are not interested persons of the fund,²⁰ after finding that:

(i) the redemption will be effected in a manner consistent with (1) through (4) above;

(ii) the redemption will not favor the affiliated shareholder to the detriment of any other shareholder,²¹ and, in the context of a registered feeder fund's redemption in kind from a registered master fund, the redemption also will not favor the master fund to the detriment of the feeder fund; and

(iii) the redemption will be in the best interests of the distributing fund; or

the adviser has the ability and the pecuniary incentive to influence the redemption in kind (e.g., when the redemption is to the adviser itself). For purposes of our position, the distributing fund's board of directors should determine whether the fund's adviser has the pecuniary incentive to influence a particular redemption in kind (e.g., whether an adviser's de minimis ownership interest in a redeeming feeder fund provides the requisite incentive) based on all of the relevant facts and circumstances. When the adviser has the pecuniary incentive to influence the redemption in kind and is not involved in the selection of the securities to be distributed, the redemption in kind nonetheless can be effected, as directed by the fund's board (e.g., a pro rata redemption in kind). See footnote 16, supra, and footnote 23, infra.

²⁰ We note that there may be instances in which it would be appropriate for a director to recuse himself from the vote on a redemption in kind due to a direct or indirect interest in the transaction (e.g., when the director is a recipient of the redemption in kind). Not every interest in a redemption in kind, however, may necessitate the recusal of a director. For example, a director's non-material ownership interest in a redeeming feeder fund may not impair his independence with respect to the redemption in kind to the feeder fund, such that it would be appropriate for him to review and approve the transaction.

²¹ We believe that, under certain circumstances, a change in the valuation of a security immediately prior to its distribution to an affiliated shareholder may indicate favorable treatment to the affiliated shareholder to the detriment of the other shareholders.

(B) the redemption in kind is effected pursuant to procedures adopted by the distributing fund's board of directors, including a majority of the directors who are not interested persons of the fund, provided that:

(i) the procedures specify the method(s) of selection of portfolio securities, and are designed to ensure that each redemption is effected in a manner consistent with (1) through (4) above;

(ii) the board of directors, including a majority of the directors who are not interested persons of the fund,²² determines no less frequently than quarterly that all redemptions in kind to affiliated shareholders made during the preceding quarter (if any):

(a) were effected in accordance with those procedures;

(b) did not favor the affiliated shareholder to the detriment of any other shareholder, and, in the context of a registered feeder fund's redemption in kind from a registered master fund, the redemption also did not favor the master fund to the detriment of the feeder fund; and

(c) were in the best interests of the distributing fund; and

(iii) the board of directors, including a majority of the directors who are not interested persons of the fund, makes and approves such changes in the procedures as the board deems necessary for monitoring compliance with (1) through (4) above;²³ and

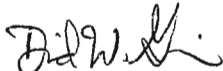
²² See footnote 20 *supra*.

²³ In our view, a fund board that approves, or adopts procedures requiring, a pro rata redemption in kind, see footnote 5, *supra*, or a pro rata redemption in kind with certain adjustments, see footnote 16, *supra*, generally would address the concerns that underlie Section 17.

In addition, in approving a particular redemption in kind to an affiliated shareholder, or in adopting procedures for approving future redemptions in kind, we believe that a fund board could use methods other than those that are pro rata-based to address the concerns that underlie Section 17.

6) the distributing fund maintains and preserves for a period of not less than six years from the end of the fiscal year in which the in-kind redemption occurs, the first two years in an easily accessible place, a copy of the board's procedures (if any), as well as other records for each redemption setting forth the identity of the redeeming shareholder, a description of the composition of the fund's portfolio immediately prior to the distribution, a description of each security distributed in kind, the terms of the in-kind distribution, and the information or materials upon which the valuation was made.

Finally, we note that those funds that have received exemptive orders permitting redemptions in kind may rely on this letter or may continue to rely on those orders. In our view, funds that wish to effect redemptions in kind as described in this letter in the future need not seek orders covering the transactions.



David W. Grim
Special Counsel

For example, we understand that, under certain circumstances in the master-feeder context, a pro rata redemption in kind to a feeder fund by a master fund that is treated as a partnership for federal tax purposes may result in a taxable event for the feeder fund. The feeder fund may avoid this taxation if it receives, in satisfaction of its redemption request, a distribution of the securities that it previously contributed to the master fund. We believe that, in this instance, a master fund board that approves, or adopts procedures requiring, a distribution of the securities contributed by the feeder fund back to that feeder fund generally would address the concerns that underlie Section 17.

WILMER, CUTLER & PICKERING

2445 M STREET, N.W.
WASHINGTON, D.C. 20037-1420

TELEPHONE (202) 663-6000
FACSIMILE (202) 663-6363

100 LIGHT STREET
BALTIMORE, MD 21202
TELEPHONE (410) 986-2800
FACSIMILE (410) 986-2828

520 MADISON AVENUE
NEW YORK, NY 10022
TELEPHONE (212) 230-8800
FACSIMILE (212) 230-8888

4 CARLTON GARDENS
LONDON SW1Y 5AA
TELEPHONE 011 (44171) 872-1000
FACSIMILE 011 (44171) 839-3537

RUE DE LA LOI 15 WETSTRAAT
B-1040 BRUSSELS
TELEPHONE 011 (322) 285-4900
FACSIMILE 011 (322) 285-4949

FRIEDRICHSTRASSE 95
D-10117 BERLIN
TELEPHONE 011 (4930) 2022-6400
FACSIMILE 011 (4930) 2022-6500

JEREMY N. RUBENSTEIN
DIRECT LINE (202) 663-6159
INTERNET JRUBENSTEIN@WILMER.COM

December 22, 1999

Investment Company Act of 1940 § 17(a)

Douglas J. Scheidt, Esq.
Associate Director and Chief Counsel
Division of Investment Management
United States Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Re: Redemptions In Kind under Section 17(a) of the Investment Company Act

Dear Mr. Scheidt:

On behalf of Signature Financial Group, Inc. ("Signature"), we respectfully request an interpretive position from the staff of the Securities and Exchange Commission ("Commission") confirming that (i) an open-end investment company's satisfaction of a redemption request from an affiliated investor by means of an in kind distribution of portfolio securities, whether or not *pro rata*, is not a "purchase" of portfolio securities by an affiliated person of the investment company for purposes of section 17(a) of the Investment Company Act of 1940 (the "Investment Company Act"), and (ii) that redemptions in kind from an underlying investment company by an investor that is itself a registered investment company do not involve sales to or purchases from the latter investment company by an affiliated person for purposes of section 17(a). In the alternative, we request assurance that the staff will not recommend that the Commission take enforcement action if an open-end investment company satisfies redemption requests by effecting distributions in kind, and if a registered investment company receives redemptions in kind from an underlying investment company, under the circumstances described in this letter.

A. Discussion

1. Redemptions In Kind and the Hub and Spoke Investment Structures

Signature is the financial services firm that developed the Hub and Spoke® and Global Hub and SpokeSM investment fund structures.^{1/} The Hub and Spoke structure involves a two-tier, master-feeder structure in which feeder funds -- the SpokeSM funds -- invest in a common master fund -- the HubSM portfolio -- in reliance on section 12(d)(1)(E) of the Investment Company Act. Typically, the Hub portfolio is a registered investment company, and one or more of the Spoke funds are registered investment companies that offer their securities publicly in the United States. Some Spoke funds may be entities other than registered investment companies, including offshore funds and other institutional investors.^{2/} The Global Hub and Spoke structure is a substantially enhanced modification of Signature's Hub and Spoke structure that is designed to comply with European and other foreign securities laws that may preclude use of the original Hub and Spoke master-feeder investment fund structure.

At times, complete or partial withdrawal from a Hub portfolio may be in the best interests of a Spoke fund and its investors, and redemption in kind may be the most appropriate way of effecting that withdrawal no matter whether or not the investors are themselves registered investment companies. For example, some Spoke funds may determine to change investment objectives in a way that deviates from the fundamental investment objectives of another Spoke fund. According to the staff, a Spoke fund that does not choose to change its fundamental investment objectives might "determine that it was in the spoke's best interest to redeem its hub shares and either seek a new hub with matching objectives or retain its own adviser to manage its portfolio consistently with those objectives."^{3/} Conversely, if a Spoke fund sought to change its investment objective when other Spoke funds investing in the same Hub portfolio did not elect to make such a change, it might be appropriate for the Spoke fund to seek a new Hub portfolio or retain its own investment adviser. A Spoke fund also might wish to withdraw if it determined that a Hub portfolio became too expensive for the Spoke fund, was not producing the economies of scale anticipated, or was under-performing other funds with similar investment objectives.

¹ The term "Hub and Spoke" is a registered service mark of Signature, and the terms "Global Hub and Spoke," "Hub," and "Spoke" are service marks of Signature.

² See "Hub-And-Spoke" Funds: A Report Prepared By The Division of Investment Management (Apr. 15, 1992) at 1-2 ("Hub-and-Spoke Funds Report"); Philip W. Coolidge, *Business Applications of the Hub and Spoke® Structure*, 1993 Mutual Funds and Investment Management Conference, at X-3; see also *Pasadena Investment Trust*, SEC No-Action Letter (Jan. 22, 1993).

³ *Hub-and-Spoke Funds Report*, *supra* note 2, at 7.

If a redemption in kind by a Spoke fund were viewed as a "purchase" or "sale" of securities by an affiliated person, it would be prohibited under section 17(a) of the Investment Company Act in the absence of an applicable exemption. The portion of a redemption in kind that might be considered a "sale" by an affiliated Spoke fund to the Hub portfolio of its interest in the Hub portfolio is expressly excluded from the prohibition in section 17(a) by section 17(a)(1)(A). There is, however, no express exclusion for the Spoke fund's receipt of a distribution in kind, which might be viewed as a "purchase" by an affiliated person of the portfolio securities distributed.

Conversely, if a Spoke fund were itself a registered investment company, its transactions with the Hub portfolio arguably could be viewed as purchases and sales by an affiliated person (the Hub portfolio) of a registered investment company (the Spoke fund). From that perspective, the Spoke fund's withdrawal from the Hub portfolio could be viewed as a purchase of an interest in the Hub portfolio by an affiliated person from a registered investment company, and the distribution of portfolio securities could be viewed as a sale by an affiliated person, and both components of the redemption in kind would be prohibited under section 17(a) in the absence of an applicable exemption. Whereas section 17(a)(1)(A) provides an express exemption for sales to an investment company of securities issued by that investment company, which precludes the redemption of an interest in a Hub portfolio from being treated as a "sale" to the Hub portfolio as an investment company by a Spoke fund as an affiliated person, section 17(a) does not contain a comparable provision expressly exempting that same portion of the transaction from being viewed as a "purchase" from a registered Spoke fund by its affiliated Hub portfolio. Moreover, from this perspective, *any* investment by a Spoke fund in an affiliated Hub portfolio could be viewed as a sale of securities to the Spoke fund by an affiliated person: while section 17(a)(1)(A) provides that an affiliate may sell to the investment company securities of which the *investment company* is the issuer, there is no comparable exemption for securities of which the *affiliated person* is the issuer.

Although the staff has issued no-action letters that permit the merger, consolidation, or transfer of substantially all of the assets of one investment company to another in the context of a Hub and Spoke structure in substantial compliance with rule 17a-8 under the Investment Company Act, those positions depend on the application of particular facts and circumstances and do not cover many potential redemptions in kind involving funds in the Hub and Spoke structure.^{4/} For example, the positions do not appear to cover the withdrawal of one Spoke fund

⁴ See *The Eaton Vance Group of Investment Companies*, SEC No-Action Letter (July 25, 1997) (no-action position regarding reliance on rule 17a-8 for reorganization of several feeder funds into multiple classes of a single feeder fund); *Principal Preservation Portfolios, Inc. and Prospect Hill Trust*, SEC No-Action Letter (Jan. 11, 1996) (no-action position concerning reliance on rule 17a-8 for the reorganization of a Hub and Spoke structure with two Spoke funds into two classes of a single fund).

Douglas J. Scheidt, Esq.

December 22, 1999

Page 4

from a Hub portfolio that continues in existence, or the withdrawal of assets from a Hub portfolio by a Spoke fund so that it may satisfy a large scale redemption by one of its own shareholders with an in kind distribution.^{5/} Thus, these positions do not provide the broader resolution of the legal status of redemptions in kind that we submit is appropriate.

Outside of the context of the Hub and Spoke structure, there often are other circumstances in which a redemption in kind by an affiliated person may be appropriate and preferable to a cash redemption. For example, a fund may have a large investor that seeks to withdraw all or part of its interest and may seek to redeem that investor's interest in a manner that is least disruptive to the fund and its remaining investors.

2. Benefits of Redemption In Kind

Redemption in kind can bring substantial benefits to fund management and to both the redeeming and non-redeeming investors and does not impose the same burdens that may fall on a fund when it has to satisfy redemption requests in cash.^{6/} If an investor seeks to redeem a substantial holding, the need to generate cash to fund the redemption proceeds may require the prompt sale of large amounts of securities and may disrupt management of the portfolio. It may be easier -- or necessary under the circumstances -- for the fund to sell the most liquid securities in its portfolio even though the fund might otherwise wish to retain those securities as long-term investments. Such a sale may leave a fund with a less liquid and more volatile portfolio, which may increase the difficulty of ongoing management and of meeting future redemption requests. Alternately, the fund may sell less liquid securities. The rapid sale of a large block of securities, however, may cause the fund to receive lower prices than it might have obtained in a more orderly disposition. Transaction costs generally must be borne by all investors, including those

⁵ Similarly, reliance on rule 17a-7 would not address fully the situations covered by our request. In addition to excluding transactions with persons who are affiliated by reasons other than having common officers, directors or adviser, that rule is available only for transactions involving certain securities for which market quotations are readily available. In some instances, it may be appropriate to transfer securities for which market quotations are not readily available but which instead are valued at fair value under procedures approved by the board of directors of the Hub portfolio.

⁶ The Commission staff noted the portfolio burdens of redemptions for cash even before the passage of the Investment Company Act. See *Investment Trusts and Investment Companies* ("Investment Trust Study"), Part Three at 807 (1940) (discussing consequences of borrowing or selling most liquid investments to fund redemptions). Subsequently, the Commission noted that large holdings by a fund of funds could "disrupt the orderly management" of underlying funds, which might have to either maintain large cash holdings or face the prospect of a damaging sale of a large amount of portfolio securities. See *Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth* at 316-18 (1966) ("PPI Report").

that do not redeem. Finally, a fund may borrow to meet redemptions. Borrowing costs are likely to be borne primarily by the remaining investors, rather than the redeeming investor.

Redemption in kind, on the other hand, can allow a fund to honor a redemption request as required by law while avoiding the disruptions of portfolio management that may be caused by cash redemptions. Redemption in kind also may provide benefits to a redeeming investor without any detriment to the remaining investors. For example, it may allow the redeeming investor to continue its investment program under different management or in a different vehicle without significant transaction costs. In some cases, in-kind withdrawals from an investment company organized as a partnership may have significant tax advantages. In light of such benefits, the Commission has recognized that it may be desirable for a fund to have the ability to redeem in kind.⁷ These benefits apply equally to investors that are themselves investment companies.

3. Section 17(a) of the Investment Company Act

Section 17(a) of the Investment Company Act, with certain exceptions, prohibits an "affiliated person" of a registered investment company from engaging knowingly in a purchase or sale of securities or other property in a transaction with that investment company.⁸ Section 2(a)(3)(A), in turn, defines "affiliated person" to include any person owning five percent or more

⁷ See, e.g., *Notice of Proposal to Adopt (1) Rule 18f-1 under the Investment Company Act of 1940 to Permit Registered Open-End Investment Companies Which Have the Right to Redeem in Kind to Elect to Make Only Cash Redemptions and (2) Form N-18F-1*, Investment Company Act Release No. 6401 (Mar. 24, 1971).

⁸ Section 17(a) provides, as is relevant:

"It shall be unlawful for any affiliated person or promoter of or principal underwriter for a registered investment company (other than a company of the character described in section 12(d)(3)(A) and (B)), or any affiliated person of such a person, promoter, or principal underwriter, acting as principal-- (1) knowingly to sell securities or other property to such registered company or to any company controlled by such registered company, unless such sale involves solely (A) securities of which the buyer is the issuer. . . . (2) knowingly to purchase from such registered company, or from any company controlled by such registered company, any security or other property (except securities of which the seller is the issuer). . . ."

of the outstanding voting securities of a company, as well as persons with other specified relationships to the company.⁹ In a Hub and Spoke structure, the Spoke funds generally would hold five percent or more of the outstanding voting interests in the Hub portfolio and thus may be viewed as affiliated persons of the Hub portfolio. Spoke funds also may be deemed affiliated for other reasons, for example by virtue of common control. Conversely, when a Spoke fund itself is a registered investment company, the Hub portfolio may be viewed as an affiliated person of the Spoke fund, by virtue of the Spoke fund's voting interest in the Hub portfolio as well as of other reasons such as common control.

Section 17(a) could thus be deemed to prohibit a redemption in kind involving a Spoke fund or other affiliated person under two analyses. First, it could be deemed to prohibit the transaction if the necessary distribution of portfolio securities were deemed a "purchase" of property by an affiliated person from the Hub portfolio. Second, it could be deemed to prohibit a redemption in kind involving a registered Spoke fund if the distribution of portfolio securities were deemed a "sale" by the Hub portfolio as an affiliated person of a registered investment company or if the redemption by the Spoke fund of interests in the Hub portfolio were viewed as a "purchase" from a registered investment company. In addition, it could be deemed to prohibit any investment by a Spoke fund in a Hub portfolio as a "sale" by an affiliated person of its own securities to the Spoke fund.

From the perspective of the Hub portfolio as a registered investment company, a redemption in kind does not involve a "sale" subject to section 17(a). The only property that could be "sold" by an affiliated investor in a redemption in kind is the investor's interest in the fund. Even assuming that the transaction were deemed a "sale," the redemption of an affiliate's interest in a registered investment company is not an impermissible affiliated transaction: section 17(a)(1)(A) permits affiliates to "sell" securities issued by an investment company back to the company without Commission approval. To the extent that a redemption in kind might be regarded as subject to the provisions of section 17(a), there thus would have to be a deemed

⁹ Section 2(a)(3) provides:

"'Affiliated person' of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof."

“purchase” of portfolio securities from the Hub portfolio by the affiliated investor by reason of the distribution in satisfaction of the redemption request.

For the reasons discussed below, we respectfully submit that redemptions in kind should not be regarded as purchases or sales of portfolio securities for purposes of section 17(a). While some administrative actions may be viewed as treating redemptions in kind from registered investment companies as subject to section 17(a), or investments and cash redemption requests by registered investment companies as subject to section 17(a), those actions should not preclude the staff from taking the position requested here. Those actions generally have involved voluntary requests for exemptive relief permitting redemptions in kind.^{10/} Uncontested exemptions granted in response to voluntary submissions are of limited value as precedent, and should not be treated as a conclusive statement of the Commission’s views.^{11/}

¹⁰ See, e.g., *Brinson Relationship Funds, et al.*, Investment Company Act Release No. 22204 (Sept. 9, 1996) (notice) (funds of funds, or other mutual funds that have the ability to invest in other investment companies, as well as in operating companies); *The Foreign Fund, Inc., et al.*, Investment Company Act Release No. 21737 (Feb. 6, 1996) (notice) (funds that invest in baskets of securities composing a market index); *The Advisors’ Inner Circle Fund*, Investment Company Act Release No. 22140 (Aug. 14, 1996) (notice) (redemptions by shareholders seeking to place assets in a separately managed account).

In addition, rule 6c-6 includes an exemption from section 17(a) to permit various transactions necessary to organize new separate accounts and new portfolio investment companies in response to an IRS Revenue Ruling, but that provision did not involve a clear statement of position by the Commission. Rather, the Commission stated only that it had “included explicit relief from section 17(a) which, absent an order pursuant to section 17(b), may prohibit some or all of the transactions attendant upon such a transfer.” *Adoption of Permanent Exemptions from Certain Provisions of the Investment Company Act of 1940 for Registered Separate Accounts and Other Persons*, Investment Company Act Release No. 12678 (Sept. 21, 1982). Indeed, in discussing potential redemptions in kind by funds of funds from underlying funds, the SEC previously assumed that such redemptions could be effected and did not raise any questions of the potential application of section 17(a). *PPI Report* at 317-18. Similarly, in discussing the status of substantial investments in a registered investment company by an off-shore fund, the staff noted that the registered company’s ability to redeem in kind was limited only by its election under rule 18f-1 under the Investment Company Act. *Pasadena Investment Trust*, SEC No-Action Letter (Jan. 22, 1993).

¹¹ “Uncontested administrative construction of this nature carries relatively little weight.” *SEC v. Sterling Precision Corp.*, 393 F.2d 214, 220 (2d Cir. 1968) (discussing exemptive orders previously issued by the Commission, granting exemptions from section 17(a)(2) of the Investment Company Act to permit redemptions by affiliated portfolio companies of their securities held by investment companies).

4. Redemptions In Kind Are Not "Purchases"

The terms "purchase" and "redemption" are not defined in the Investment Company Act, and the Investment Company Act does not specify that redemptions in kind are subject to section 17(a). Accordingly, the appropriate treatment of a redemption in kind must be divined by an examination of both the ordinary meaning of the term "purchase" and how that meaning may be affected by the underlying policies and the provisions of the Investment Company Act. At least part of this examination was performed by Judge Friendly in *SEC v. Sterling Precision Corp.*^{12/}

In *Sterling Precision*, the court considered whether section 17(a) applied to a redemption of convertible debentures and convertible preferred stock issued by Sterling Precision and owned by The Equity Corporation, a registered investment company. Because the convertible preferred stock held by The Equity Corporation represented 11.8% of Sterling Precision's outstanding voting securities, Sterling Precision was a downstream affiliated person of The Equity Corporation. Both the convertible debentures and the convertible preferred stock were redeemable by Sterling Precision at any time at specified prices. Sterling Precision decided that it wanted to terminate its status as an affiliate of The Equity Corporation, and called the securities owned by The Equity Corporation in substantial compliance with their terms.^{13/}

The court held that Sterling Precision's redemption of its securities did not constitute a "purchase" of those securities by an affiliate prohibited by section 17(a)(2) of the Investment Company Act.^{14/} Judge Friendly observed that "the normal discourse of lawyers sets redemptions apart from purchases."^{15/} Moreover, the decision noted that common usage did not regard a redemption as a "purchase" and that the Investment Company Act did not appear to require that all transactions with affiliates -- particularly the "sale" of securities issued by an investment company back to the company -- be regarded as purchases or sales for purposes of

¹² 393 F.2d 214 (2d Cir. 1968).

¹³ There was a minor deviation from the terms of the indenture applicable to the convertible bonds, which required that any partial redemption be effected on a *pro rata* basis among all holders. There were two other holders that continued to own debentures and who consented to the transaction based on an agreement by Sterling Precision to pay a higher rate of interest thereafter. Judge Friendly ruled that, since Sterling could have redeemed the debentures completely and issued new debentures to the remaining two holders, any deviation was not substantial.

¹⁴ The Commission has since exempted most transactions with pure downstream affiliates -- entities that are affiliated persons simply because they are owned by the investment company -- from the provisions of section 17(a). See *Exemption of Transactions by Investment Companies with Certain Affiliated Persons*, Investment Company Act Release No. 10828 (Aug. 13, 1979) (amending rule 17a-6).

¹⁵ *Sterling Precision* at 217.

section 17(a).^{16/} The court concluded that Congress did not intend to include redemptions in accordance with a security's terms within the term "purchase" as used in section 17(a)(2).^{17/}

On rehearing, the court examined whether the exception in section 17(a)(1)(A) covering "sales" of investment company securities back to the issuer established that other redemptions should be regarded as purchases for purposes of section 17. The court considered the argument that the exception in section 17(a)(1)(A) was explicable in light of the general provisions relating to the redemption of investment company securities and related matters in sections 22 and 23 of the Investment Company Act, presumably meaning that the court should not permit redemption transactions involving affiliated persons that were not covered by that explicit exception. The Court responded that, to the contrary, inspection of sections 22 and 23 established that Congress enacted basic safeguards that apply to all redemptions and "did not regard affiliation as calling for special treatment of redemptions."^{18/}

We recognize, of course, that Judge Friendly's opinion did not reach the question of whether a distribution of portfolio securities by an open-end investment company to satisfy its legal obligation to redeem securities issued by it constitutes a "purchase" of the portfolio securities for purposes of section 17(a). We believe that the analysis concerning Congressional intent and the structure of the Investment Company Act is, nonetheless, equally instructive in analyzing the status of redemptions in kind under the Investment Company Act.

5. Inconsistency of Treatment of Redemptions In Kind as "Purchases" with the Structure of the Investment Company Act

As is the case with redemptions in cash, we believe that treating redemptions in kind as "purchases" by an affiliated investor from the underlying investment company for purposes of section 17(a) would be inconsistent with both the common usage of the term "purchase" and the structure and intent of the Investment Company Act. Under common usage, the term "purchase" implies that there is a *quid pro quo* in which the purchaser contracts to acquire the purchased property. Yet the Investment Company Act clearly places the decision as to whether to redeem in cash or in kind in the hands of the investment company: the redeeming investor merely is entitled to its approximate share of net assets or the cash equivalent thereof. The investor has no right to determine the nature of those assets. At the same time, section 17(a) does not make it illegal for an investment company to engage in a transaction with an affiliate -- the prohibition falls entirely on the affiliated person. Interpreting section 17(a)(2) to apply to redemptions in

¹⁶ *Id.* at 218.

¹⁷ *Id.*

¹⁸ *Id.* at 220.

kind could place an affiliated investor in the peculiar position of violating the Investment Company Act based on actions outside of its direction or control.

More broadly, to construe redemptions in kind with affiliates as prohibited by section 17(a)(2) would nullify a basic part of the legal relationship between a fund and certain investors. Redemption in kind is a key term of the securities issued by open-end companies: the definition of "redeemable security" expressly provides that the holder must be entitled to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof.^{19/}

A position that funds may not make redemptions in kind to investors that are affiliated would mean that differing groups of investors (affiliated and unaffiliated) in effect would own securities with differing redemption provisions. Such a difference in treatment might involve the creation of a "senior security," which is prohibited by section 18(f) of the Investment Company Act,^{20/} as the Commission previously recognized in adopting rule 18f-1 under the Investment Company Act.^{21/} The Commission promulgated rule 18f-1 in response to initiatives of state and foreign securities regulators seeking undertakings by mutual funds that the funds would only pay cash on redemptions by residents of those jurisdictions. The Commission stated that the existence of such requirements in some jurisdictions but not others "would involve priorities as to the distribution of assets and thus give rise to prohibited senior securities within the meaning of Section 18 of the [Investment Company] Act."^{22/}

6. Regulation of Redemptions Under the Investment Company Act

Rather than being subject to section 17(a), we believe that redemptions are subject to a separate system of regulation under sections 22 and 23 of the Investment Company Act, which

¹⁹ Section 2(a)(32) provides: "'Redeemable security' means any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof."

²⁰ Section 18(f) prohibits an open-end company from issuing or selling any senior security, except that limited bank borrowing is permitted. Section 18(g), in pertinent part, defines a senior security as "any stock of a class having priority over any other class as to distribution of assets or payment of dividends."

²¹ Rule 18f-1 allows an investment company to waive the right to redeem in kind for redemption requests not exceeding \$250,000 or one percent of the company's net asset value, whichever is less, during any 90-day period.

²² Release 6401, *supra* note 7.

provide "certain basic safeguards" for all redemptions as recognized in *Sterling Precision*.^{23/} Foremost among those safeguards for open-end funds is the obligation to redeem securities promptly pursuant to section 22(e): that section provides that an issuer of redeemable securities may not suspend the right of redemption or postpone the date of payment or satisfaction upon redemption for more than seven days, except in certain limited circumstances when it may not be feasible to sell or value portfolio securities. Section 22(e) responded to the chief evils of redemptions noted in the legislative history, which related to suspensions of redemptions or failures to honor redemption provisions generally.^{24/}

In addition to assuring the basic right of redeemability, Congress enacted safeguards for the terms on which redemptions are effected. The definition of "redeemable security" provides for redemptions to be effected at approximately an investor's proportionate share of the fund's net assets. Congress also empowered the NASD and the Commission to regulate the relationship between a fund's current net asset value and the prices at which redeemable securities are sold and redeemed in order to eliminate or minimize any dilution of the value of the shares of the non-redeeming investors.^{25/} Under that authority the Commission has promulgated rules to ensure that sales and redemptions are effected at fair prices that will not dilute the interests of non-redeeming investors or confer unfair benefits on the redeeming investors. Rule 22c-1 provides that sales and redemptions must occur at the next net asset value determined after the purchase or redemption order is received.^{26/} Rule 2a-4 specifies how that net asset value must be

²³ 393 F.2d at 220.

²⁴ See *Investment Trusts and Investment Companies: Hearings before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess., pt. 2, at 985-90 (1940) ("Senate Hearings")*. The Commission staff noted, for example, that some funds had modified their redemption provisions to require up to 48 days' or a year's advance notice before payment. Other funds had taken advantage of provisions in their declarations of trust permitting redemptions to be suspended under certain circumstances, such as the listing of the funds' shares on any securities exchange, even though the funds' disclosure documents made no mention of those provisions. In addition to section 22(e), section 13(a)(1) of the Investment Company Act addressed some of those abuses by prohibiting a fund from converting from open-end to closed-end status (or vice versa) without a vote of a majority of the outstanding voting securities.

²⁵ Sections 22(a) and (c).

²⁶ Rule 22c-1 provides that sales, redemptions and repurchases of redeemable securities by registered investment companies, principal underwriters, dealers, and other persons designated in the prospectus as authorized to effect transactions, shall be effected at the net asset value next determined after the receipt of tender for redemption or of a purchase or sale order. The rule also specifies minimum requirements for the frequency and timing of computation of net asset value.

determined.^{27/} Taken together, these provisions require all redemptions to be effected at prices that are not advantageous to redeeming investors or disadvantageous to non-redeeming investors.

In contrast to the specific regulation of the valuation and timing of redemptions, Congress did not choose to enact any provisions restricting redemptions in kind. Redemption in kind was a feature of many open-end companies before the passage of the Investment Company Act, yet the legislative history of the Investment Company Act is devoid of any indication of Congressional or Commission concerns about any redemptions in kind.^{28/} Moreover, the Commission staff study of the investment company industry that led to the passage of the Investment Company Act did not raise any problems with the application of redemption in kind provisions. Instead, as noted above, the study focused on problems in liquidating portfolio securities and abusive delays or suspensions of redemption, most or all of them relating to redemptions in cash, and did not involve any inequities or other problems involving redemptions in kind.^{29/}

Rather, the Investment Company Act seems to contemplate that open-end companies enjoy the flexibility to determine whether to redeem in kind or in cash. A direct result of the statutory obligation to redeem securities promptly after a tender is that it may be necessary or desirable to effect large scale redemptions in kind. The Investment Company Act generally gives the decision whether to redeem in cash or in kind to the management of the fund: as noted above, the definition of "redeemable security" expressly provides that the holder must be entitled to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof. The Commission has noted that "[t]his provision has traditionally been interpreted as giving the issuer the option of redeeming its securities in cash or in kind."^{30/}

²⁷ Rule 2a-4 under the Investment Company Act requires the current net asset value of a fund for purposes of distribution, redemption and repurchase to be computed according to specified requirements, including the use of current market value for all portfolio securities for which market quotations are available, and of fair value as determined in good faith by the board of directors for all other assets.

²⁸ *Senate Hearings, supra* note 24, at 989-91 (reproducing SEC staff memorandum that summarized redemption provisions of several open-end companies).

²⁹ Most of the problems in the area of redemptions noted by the SEC staff before the passage of the Investment Company Act involved either suspensions of redemption, as discussed above, or the practical difficulties of raising cash to pay redemption proceeds. *See supra* notes 6 (difficulties of raising cash) and 24 (suspensions of redemptions). There was no discussion of any consequences of or problems with redemptions in kind.

³⁰ Release 6401, *supra* note 7.

7. Protections Under the Investment Company Act

As a matter of policy, the position we are requesting would not eliminate the application of the Investment Company Act to, and would confirm the existence of substantial investor protections for, redemptions in kind. As discussed above, the pricing and valuation requirements under the Investment Company Act applicable to redemptions generally specify the prices at which any redemptions might be effected. So long as a fund's portfolio securities are being valued consistently and in compliance with those requirements, a redemption in kind ensures that affiliated investors do not obtain portfolio securities at a more advantageous price than the market value or fair value normally used in determining net asset value and effecting purchases and redemptions by all investors.^{31/}

Thus, the pricing provisions directly applicable to redemptions already address the concerns about affiliated transactions at disadvantageous prices that underlie section 17(a).^{32/} By contrast, no such requirements of pricing and valuation govern actual purchases or sales of portfolio securities. The Investment Company Act does not regulate the amount or form of consideration that is permissible in those transactions. Accordingly, it is appropriate and consistent with the overall statutory scheme to subject those other dispositions, but not redemptions in kind, to the prohibition of section 17(a).

The Act and other applicable law also provide ample protections against potential abuses in the distribution of particular portfolio securities. In determining which securities to distribute in a redemption in kind, just as in determining which securities to liquidate to pay cash redemption proceeds, fund directors, and advisers as the board's delegates are subject to strict fiduciary duties under federal and state law^{33/} and to specific obligations relating to valuation,

³¹ Cf. *Sterling Precision*, 393 F.2d at 219 (recognizing that the repurchase of bonds for less than the specified redemption price would be a "purchase" subject to 17(a)(2)).

³² In the case of purchases and sales of portfolio securities, the legislative history identified various abusive practices, mostly involving sales of securities to investment companies by their sponsors at prices other than the market price. The *Investment Trust Study*, *supra* note 6, discussed several problems that had occurred in the sale of portfolio securities to investment companies. Problems included: sales of securities to the company before or at the time of organization of the company in transactions the terms of which "could not easily be verified independently" (at 2583); sales to the company, before or at the time of organization, of large blocks of securities at prices higher than could be obtained in the market for such blocks (2585-86); post-organization sales to the company of unlisted or thinly traded securities and of securities above their market prices, (2590-91); and the sale of securities to the company to serve as a vehicle for the sponsor to control the portfolio companies (2599-2601).

³³ Investment company advisers and directors are subject to fiduciary duties of care and loyalty
(continued...)

redemptions.^{34/} Those duties require management of the portfolio in the interests of all investors and thus provide a constraint preventing redemptions in kind from being effected to the detriment of unaffiliated investors. The possibility that a fund might transfer its most liquid portfolio securities to an affiliate is counter-balanced by the fund's ongoing obligation to maintain a sufficiently liquid portfolio to meet future redemptions.^{35/} Moreover, failure to allow a fund to redeem in kind often would have the exact opposite effect to what was intended: a fund might be *forced* to sell its most liquid assets to satisfy an obligation to an affiliate.

On some occasions, Commission exemptive orders involving redemptions in kind with affiliates have required portfolio securities to be distributed on approximately a *pro rata* basis.^{36/} The Investment Company Act, however, does not require redemptions in kind to be effected *pro rata* -- either in general or in the case of affiliated investors.^{37/} Instead, the determination of the most appropriate means to effect a redemption in kind -- whether through a *pro rata* distribution or some other procedure -- is best left to fund management, in the fulfillment of its fiduciary duties, and in light of multiple considerations that apply to any portfolio management decision,

³³ (...continued)

under state statutory and common law. Section 36(a) of the Investment Company Act provides that the Commission may bring an action against a fund director, its investment adviser, or principal underwriter for breach of fiduciary duties involving personal misconduct. In addition, investment advisers that are registered under the Investment Advisers Act of 1940 are subject to strict fiduciary duties under section 206 of the Advisers Act. Investment advisers that are banks also are subject to fiduciary duties under state or other applicable law and federal banking law.

³⁴ Under section 2(a)(41) of the Act, in the absence of market quotations, "fair value" for portfolio securities must be determined in good faith by the board of directors or in accordance with procedures approved by the board. Under rule 22c-1, the board must approve the time of pricing for sales and redemptions.

³⁵ See, e.g., *Statement Regarding 'Restricted Securities,'* Investment Company Act Release No. 5847 (Oct. 21, 1969); *Revisions of Guidelines to Form N-1A,* Investment Company Act Release No. 18612 (Mar. 12, 1992) (modifying Guide 4 to Form N-1A to state that the usual limit on holdings of illiquid assets is fifteen percent of a fund's net assets).

³⁶ See, e.g., *The Advisors' Inner Circle Fund,* Investment Company Act Release No. 22581 (Mar. 25, 1997) (notice). Other funds have not used a principle of *pro rata* redemption in kind. See, e.g., *GMO Core Trust,* Investment Company Act Release No. 15979 (Sept. 15, 1987) (notice).

³⁷ The provision relating to redemptions in kind in section 2(a)(32) of the Investment Company Act (the definition of redeemable security) does not call for *pro rata* redemptions. Instead, it contemplates only that an investor receives "approximately" his or her share of the fund's net assets, *i.e.*, that the portfolio securities received by the investor have approximately the same value as the net asset value of the investor's interest in the fund.

including liquidity requirements, diversification requirements, and individual funds' investment objectives and restrictions. A fund also may need to make adjustments for odd lots, fractional shares, or other commercially viable units, restricted securities, foreign securities that may be held only by certain investors including investment companies, or other assets that, though liquid, must be traded in the market or with a counterparty in order to effect a change in ownership. These determinations must be made regardless of whether a fund effects a redemption in cash or in kind.

The determination of which securities are distributed in a redemption in kind should be effected in accordance with procedures specifying the manner of distribution depending on the circumstances. In light of the substantial portion of a Hub portfolio represented by the interest of a Spoke fund, and of the board's fiduciary duties under state law and section 36(a) of the Act and its related obligations involving redemptions and pricing, it is incumbent on the board of the Hub portfolio to approve these procedures and any material deviations from those procedures in practice. By specifying the manner in which securities are to be distributed in a redemption in kind, such procedures would have the effect of preventing favoritism among investors and reminding advisers and directors of their fiduciary duties. In addition, they would provide a documentary basis for examiners and investors to confirm that redemptions in kind were properly effected.

Finally, we note that a purported "redemption" involving a distribution of securities *in excess of* the affiliated person's approximate proportionate share of the fund's net assets would not be a redemption within the usage of the Investment Company Act and would be a "purchase" of those securities subject to the prohibitions of section 17(a). When Judge Friendly held that a redemption of a security was a discharge of an obligation rather than a prohibited "purchase," he noted that "discharge through payment is effected only when a security is paid off in substantial accordance with its terms."^{38/} Accordingly, Judge Friendly preserved the application of the Investment Company Act to transactions that did not fit within the redemption rights of the holder. In such a case, the Commission and private parties could bring an action against the putatively redeeming investor for violating section 17(a).

8. Investments and Redemptions by an Investor that is a Registered Investment Company Do Not Involve Purchases or Sales

Although the Investment Company Act does not define the terms "purchase" and "redemption," it does define the term "sale," which potentially could be read to apply to a registered Spoke fund's investment in an affiliated Hub portfolio and to the transfer to a registered Spoke fund of portfolio securities by an affiliated Hub portfolio. Section 2(a)(34) of

³⁸ *Sterling Precision*, 393 F.2d at 219.

the Investment Company Act provides in pertinent part: "unless the context otherwise requires-- * * * 'sale,' 'sell,' 'offer to sell,' or 'offer for sale' includes every contract of sale or disposition of, attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." While both an investment and a transfer of portfolio securities as part of a redemption in kind may be viewed as involving a disposition of securities for value, we submit that the particular circumstances of the relationship between registered investment companies operating within the parameters of section 12(d)(1) *does* provide a situation in which "the context otherwise requires." In particular, we note that without reliance on the introductory "context" caveat in section 2, it would be impossible to have *any* funds operating in a master-feeder structure -- a result that clearly is contrary to the basic statutory scheme.

Section 12(d)(1)(A) of the Investment Company Act restricts the ability of one investment company to invest in securities issued by other investment companies. In pertinent part, section 12(d)(1)(A) prohibits an investment company and companies controlled by it (the "acquiring company"), from acquiring in the aggregate more than 3% of the outstanding voting stock of another investment company (the "acquired company") or securities of acquired companies totaling more than 10% of the acquiring company's assets. Section 12(d)(1)(B) imposes comparable restrictions on the seller's side.

The Investment Company Act, however, expressly permits investment companies to invest in other investment companies in excess of those limits under certain circumstances. In particular, master-feeder arrangements such as the Hub and Spoke structure operate under an exception to the general prohibition -- section 12(d)(1)(E) -- which permits an investment company (a feeder) to own securities issued by another investment company (a master) without limitation of amount so long as certain requirements are satisfied.

Section 12(d)(1) thus clearly contemplates that investment companies may invest in other investment companies to an extent that would make them affiliated persons of each other and that the investing companies may act as investors without restrictions other than those specified in section 12(d)(1). To construe section 17(a) to apply to transactions between these investment companies would nullify the purpose of the exemptions in section 12(d)(1). To apply section 17(a) would mean that once a registered investment company reached a holding equal to five percent of the voting securities of an underlying company, thus making the underlying company an affiliated person, the investing company could invest no further and could not redeem, either in kind or for cash, its interest in the underlying company.

Under an expansive view, once a registered Spoke fund acquired more than five percent of the voting securities of a Hub portfolio, the Hub portfolio would be an affiliated person of the Spoke fund within the meaning of section 2(a)(3) of the Act. Since section 17(a) does not permit an affiliated person to sell securities of which it is the issuer to the registered investment company of which it is an affiliated person, *any* increase in the Spoke fund's interest in the Hub

portfolio would be prohibited if section 17(a) is construed to apply to the master-feeder setting. Thus, once the Spoke fund made its initial investment, it would be unable to make any additional investments to reflect the Spoke fund's sale of its shares to investors. Similarly, once the Spoke fund acquired more than five percent of the voting interests in the Hub portfolio, the Hub portfolio would be an affiliated person, and a redemption for cash could be considered a purchase by the affiliated Hub portfolio of securities from a registered investment company and prohibited likewise. Thus, a Spoke fund would be unable to redeem its investment in the Hub portfolio even in order to meet redemption requests by the Spoke fund's own shareholders. For the same reason, the component of a redemption in kind involving a distribution of portfolio securities by a Hub portfolio would be considered a sale to a registered investment company and also prohibited. In sum, the application of section 17(a) would nullify the basic investor-investee relationship between two registered investment companies that the exceptions in section 12(d)(1) are intended to permit.

Such a result cannot be what Congress contemplated in allowing feeder funds to acquire more than three percent of underlying master funds. The legislative history of section 12(d)(1) is devoid of any indication that investment companies that invested in underlying investment companies were to be subject to limits on their ability to invest or redeem (absent an express limit such as that set forth in section 12(d)(1)(F)) or that redemptions in kind were to be treated differently than redemptions for cash. Indeed, in its recommendations that led to the current restrictions in section 12(d)(1), the SEC assumed that redemptions by funds of funds from underlying funds could be effected through redemptions in kind without raising any questions of the applicability of section 17(a).^{39/} Although some of that discussion involved investments by unregistered foreign funds of funds, the context also addressed registered funds of funds, which were permissible at the time since section 12(d)(1) did not then prohibit an acquiring company from acquiring securities of acquired companies exceeding ten percent of its assets.

As a matter of policy, it also is unnecessary to seek to apply section 17(a) to investment and redemption transactions between two registered investment companies in light of the substantial other protections available under the Investment Company Act. First, when as here, the affiliated person is itself a registered investment company issuing redeemable securities, purchases and redemptions of those securities are subject to pricing and valuation provisions under the Investment Company Act, which ensure that those transactions are effected at a fair price that does not provide any advantage or disadvantage to the investing registered investment company.^{40/}

³⁹ *PPI Report* at 316-17.

⁴⁰ *See* Investment Company Act section 2(a)(41) and rule 22c-1.

That relationship also provides substantial protections for the component of a redemption in kind involving the distribution of portfolio securities. The adviser and the board of the Hub portfolio have fiduciary duties to the Hub portfolio as a whole and to all investors in the Hub portfolio that require them to ensure that redemptions in kind do not involve the distribution of particular portfolio securities so as to confer a particular disadvantage or advantage upon a particular Spoke fund. In particular, the fiduciary duties of the board of the Hub portfolio require it to approve redemption in kind procedures designed to treat all investors fairly. In addition, given the vital importance of investments and redemptions in an underlying Hub portfolio, the board of the Spoke fund would have its own fiduciary duty to review, and monitor the application of, the redemption in kind procedures of the Hub portfolio in which that Spoke fund invests.^{41/}

C. Conclusion

For the reasons stated above, we respectfully request the assurance of the staff that (i) an open-end investment company's satisfaction of a redemption request from an affiliated investor by means of an in kind distribution of portfolio securities, whether or not *pro rata*, is not a "purchase" of portfolio securities by an affiliated person of the investment company for purposes of section 17(a) of the Investment Company Act of 1940 (the "Investment Company Act"), and (ii) that redemptions in kind from an underlying investment company by an investor that is itself a registered investment company do not involve sales to or purchases from the latter investment company by an affiliated person for purposes of section 17(a). In the alternative, we request assurance that the staff will not recommend that the Commission take enforcement action if an

⁴¹ Section 17(a) would, of course, apply to transactions between a registered investment company and an affiliated person that is not also a registered investment company. For example, if a non-investment-company, affiliated person of a registered investment company sought to acquire securities issued by the investment company in exchange for a contribution in kind of various securities holdings, that affiliated person would not be subject to any pricing or valuation requirements or other comparable protections that do exist for the transactions covered by our request here. In those circumstances, the implied exception of section 12(d)(1) would not be applicable.

Douglas J. Scheidt, Esq.
December 22, 1999
Page 19

open-end investment company satisfies redemption requests by effecting distributions in kind, and if a registered investment company receives redemptions in kind from an underlying investment company, under the circumstances described in this letter. Please call Jeremy N. Rubenstein at (202) 663-6159 or Robert G. Bagnall at (202) 663-6974 if you would like additional information or to discuss these matters further.

Sincerely,

A handwritten signature in cursive script, appearing to read "Jeremy Rubenstein". The signature is written in dark ink and is positioned above the printed name.

Jeremy N. Rubenstein