April 4, 2017

SEC Approves U.S. Master Fund/Foreign Feeder Fund Arrangement – Section 12(d)(1)(E)

On March 8, 2017, the SEC staff issued a no-action letter (the "Letter") providing assurance with respect to a plan for foreign-regulated investment companies ("Foreign Feeder Fund") to invest exclusively in corresponding SEC-registered open-end master funds ("U.S. Master Fund"). The no-action assurance was conditioned upon compliance with the requirements of Section 12(d)(1)(E) of the 1940 Act, as modified by the Letter.

According to the Letter's applicant (the "Applicant"), the Letter will assist global investment managers that seek to offer an investment product across multiple foreign jurisdictions using the proposed master-feeder structure (the "Proposed Structure").

Need for the Letter. Sections 12(d)(1)(A) and (B) of the 1940 Act limit investments by investment companies, including Foreign Feeder Funds, in U.S.-registered funds.[1] These investment limitations were incorporated into the 1940 Act due to concerns about undue influence that an acquiring fund might otherwise have over an acquired fund, to avoid layering of fees that result in higher total fees for an acquiring fund's investors and to eliminate overly complex fund structures that make it difficult for an acquiring fund's investors to understand and evaluate their holdings.

Section 12(d)(1)(E) provides an exemption from Sections 12(d)(1)(A) and (B)'s investment limitations, subject to certain conditions. Without the Letter, Section 12(d)(1)(E) would have required the following with respect to the Proposed Structure:

1. The principal underwriter of a Foreign Feeder Fund would have to be a registered broker-dealer under the Exchange Act or a person controlled by such a broker-dealer,

2. Shares of a U.S. Master Fund would have to be the only investment securities held by a Foreign Feeder Fund, and

3. A Foreign Feeder Fund would have to acquire shares of a U.S. Master Fund pursuant to an arrangement requiring the Foreign Feeder Fund to seek instructions from its shareholders regarding the voting of all proxies concerning shares of the U.S. Master Fund or, instead, to vote those shares in the same proportion as the vote of all the other shareholders of the U.S. Master Fund (*i.e.*, echo-voting).

Because these Section 12(d)(1)(E) conditions were unworkable for the Proposed Structure, the Applicant made various representations and proposed certain conditions intended (i) to mitigate the concerns that led Congress to enact Sections 12(d)(1)(A) and (B) and (ii) to ensure that the SEC maintained jurisdiction over persons whose

[1] Section 12(d)(1)(A) would prohibit a Foreign Feeder Fund from (i) acquiring more than 3% of a U.S. Master Fund's shares, (ii) investing more than 5% of its assets in a single U.S. Master Fund or (iii) investing more than 10% of its assets in SEC-registered investment companies. Section 12(d)(1)(B) would prohibit a U.S. Master Fund, its principal underwriter and any registered broker-dealer from knowingly selling shares of a U.S. Master Fund to a Foreign Feeder Fund if, immediately after such sale, (i) the Foreign Feeder Fund would own more than 3% of the U.S. Master Fund's outstanding shares or (ii) more than 10% of the U.S. Master Fund's outstanding shares would be owned by the Foreign Feeder Fund and other investment companies.

activities outside the U.S. have an effect on U.S. persons. These representations and conditions are summarized below.

Section 12(d)(1)(E)(i)'s "Jurisdictional" Condition. Contrary to Section 12(d)(1)(E)'s first condition, in the Proposed Structure, the principal underwriter of a Foreign Feeder Fund would not necessarily be registered as a broker-dealer under the Exchange Act (in some instances, the Foreign Feeder Fund would have no principal underwriter). In the Letter, the SEC staff agreed that this condition is intended to ensure that the SEC has jurisdiction over, and the ability to pursue claims against, the principal underwriter of an acquiring fund in a master-feeder fund structure.

In the Letter, the staff accepted that the Applicant's arguments that the following conditions would address the jurisdictional concerns underlying Section 12(d)(1)(E)'s first condition:

- Each Foreign Feeder Fund will be managed either by (i) a U.S. Master Fund's registered investment adviser or (ii) an investment adviser not registered with the SEC that is controlled by or under common control with (a "Control Affiliate") the U.S. Master Fund's investment adviser, the U.S. Master Fund's principal underwriter and the Foreign Feeder Fund's principal underwriter (if applicable). Therefore, the U.S. Master Fund's investment adviser, the U.S. Master Fund's principal underwriter, the Foreign Feeder Fund's investment adviser and the Foreign Feeder Fund's principal underwriter (if applicable) will be affiliated persons of each other.

- If the Foreign Feeder Fund's investment adviser is not registered with the SEC (unless the Foreign Feeder Fund's principal underwriter is a U.S.-registered broker-dealer), the Feeder Fund's investment adviser will submit to the SEC a written consent agreeing to make its books and records with respect to the activities of the Foreign Feeder Fund available to the SEC and its staff, designate the U.S. Master Fund's investment adviser as its agent for service of process in the U.S. with respect to the Foreign Feeder Fund, and consent to the jurisdiction of the U.S. courts and the SEC regarding its actions related to the Foreign Feeder Fund.

- If a Foreign Feeder Fund has a principal underwriter, that principal underwriter will either (i) be a U.S.-registered broker-dealer or (ii) submit to the SEC a written consent agreeing to make its books and records with respect to the activities of the Foreign Feeder Fund available to the SEC and its staff, designate the U.S. Master Fund's investment adviser as its agent for service of process in the U.S. with respect to the Foreign Feeder Fund, and consent to the jurisdiction of the U.S. courts and the SEC regarding its actions related to the Foreign Feeder Fund.

- Each Foreign Feeder Fund will be organized in, and regulated under the laws of, one of the following jurisdictions: France, Germany, Ireland, Luxembourg, Switzerland, the United Kingdom, Canada, Mexico, Brazil, Australia, Hong Kong, Japan, Singapore or South Africa (the "Permitted Jurisdictions"). The SEC has entered into a cooperation arrangement with the securities regulator(s) in each of the Permitted Jurisdictions. In addition, Foreign Feeder Funds would be limited to foreign publicly offered investment vehicles whose securities are either generally redeemable upon demand to the fund or are listed on one or more foreign securities exchanges, and would be investment companies as defined in Section 3(a)(l)(A) of the 1940 Act. Thus, Foreign Feeder Funds would be the foreign equivalent of U.S.-registered mutual funds, closed-end funds or ETFs.

- No Foreign Feeder Fund will offer or sell its securities in the U.S. or sell its securities to any "U.S. person" (as defined in Rule 902(k) under Regulation S of the Securities Act); each Foreign Feeder Fund's transactions with its shareholders will be consistent with the definition of "offshore transactions" within Rule 902(h) of Regulation S; and no Foreign Feeder Fund, Feeder Fund's investment adviser or foreign principal underwriter, any of their affiliates, or any person acting on behalf of any of these entities, will engage in any

"directed selling efforts," as defined in Rule 902(c) of Regulation S, with respect to shares of a Foreign Feeder Fund in the U.S.

Section 12(d)(1)(E)(ii)'s "Only Investment Security" Condition. Contrary to Section 12(d)(1)(E)'s second condition, in addition to investing in the securities of a single U.S. Master Fund, a Foreign Feeder Fund also may invest in foreign currency and foreign currency-related instruments ("Foreign Currency Instruments"). The investments in Foreign Currency Instruments would be for the purpose of hedging against fluctuations in the value of the U.S. dollar relative to the currency of the foreign jurisdiction in which securities of the Foreign Feeder Fund are sold (the "Designated Currency"). This would permit shareholders of a Foreign Feeder Fund to achieve a return, as measured in its Designated Currency, similar to that achieved by shareholders of the U.S. Master Fund, as measured in U.S. dollars ("Feeder-Level Hedging").

In the Letter, the staff accepted the Applicant's reliance on an earlier no-action letter (involving foreign funds investing in U.S.-registered funds and using a currency hedging strategy similar to Feeder-Level Hedging) in which the SEC staff stated that "the [foreign fund's] proposed use of the [Foreign Currency Instruments] would not create any incentive to exercise any improper influence over the Underlying Fund because the same investment adviser advises both of these funds."[2] The Applicant also represented that a Foreign Feeder Fund will hold Foreign Currency Instruments for the sole purpose of hedging against fluctuations between the Designated Currency and the U.S. dollar and would not hold Foreign Currency Instruments for speculative purposes (*i.e.*, not for the purpose of generating excess investment returns).

The Applicant acknowledged that another currency strategy could create an incentive for a Foreign Feeder Fund to attempt to influence its U.S. Master Fund. A Foreign Feeder Fund may be more or less affected than its U.S. Master Fund by the currency exposure of the U.S. Master Fund's *portfolio*. In such a case, a Foreign Feeder Fund could try to hedge against the currency exposure of its U.S. Master Fund's *portfolio* to the Foreign Feeder Fund's Designated Currency ("Master-Level Hedging"). Nonetheless, the staff agreed that a divergence could arise between the interests of the Foreign Feeder Fund and the U.S. Master Fund under these circumstances because a Foreign Feeder Fund arguably has an incentive to influence the currency exposure of the U.S. Master Fund's portfolio.

In the Letter, the SEC staff accepted the representation that Master-Level Hedging would be employed only by a Foreign Feeder Fund that invests in a U.S. Master Fund that is an index fund. The staff agreed that a U.S. Master Fund that is an index fund would have very limited opportunity to alter its portfolio's currency exposure for the purpose of benefitting a Foreign Feeder Fund and, therefore, the U.S. Master Fund would not be susceptible to the potential influence of a Foreign Feeder Fund.

Section 12(d)(1)(E)(iii)'s Pass-Through or Echo-Voting Condition. The Applicant stated that the laws and/or market practices of a Foreign Feeder Fund's jurisdiction might not permit pass-through or echo-voting as required by Section 12(d)(1)(E)(iii). In the Letter, the staff agreed that these voting requirements are intended to mitigate concerns about undue influence that an acquiring fund might exercise over an acquired fund. The Applicant represented that under the Proposed Structure, each Foreign Feeder Fund will either abstain from voting or withhold voting the shares of the U.S. Master Fund. The staff agreed that this practice would neutralize the vote of a Foreign Feeder Fund, as if the Foreign Feeder Fund echo-voted the shares.

Discussion. The Letter is an important first step for investment managers that seek to offer an investment product in the Permitted Jurisdictions using the efficiency of a global U.S. Master Fund. Achieving that goal may require the securities regulator(s) in each Permitted Jurisdiction to permit a locally regulated investment company to invest exclusively in a U.S. Master Fund. It also is possible that a Permitted Jurisdiction may seek reciprocity on the part of

[2] PIMCO Funds, SEC No-Action Letter (pub. avail. July 9, 2002).

the SEC – to permit a U.S.-registered investment company to invest exclusively in a regulated non-U.S. master fund – as a condition to providing any necessary regulatory relief within the Permitted Jurisdiction.[3]

Local competition and legal obstacles may hinder Foreign Feeder Funds' penetration of some Permitted Jurisdictions. For example, in the established cross-border fund jurisdictions in Asia (Hong Kong, Singapore and Taiwan), funds established under the European UCITS directives have already gained significant local acceptance. However, it should be noted that the UCITS Directive prescribes a number of diversification requirements for permitted underlying investments of a UCITS fund. Consequently, more analysis would be required to understand if this development would be a useful tool to allow a UCITS fund to invest wholly in a U.S Master Fund. An alternative to the UCITS regime could be to take advantage of the wider investment powers remit permitted under the EU's Alternative Investment Fund Managers Directive (the "AIFMD") because the AIFMD does not set out investment restrictions as set out in the UCITS Directive. However, such funds would not be able to be marketed to retail investors in the same manner as a UCITS fund.

Finally, knowledge of local distribution models and investor preferences, which vary significantly among the Permitted Jurisdictions, and experience creating foreign regulated entities and operating foreign registered investment products are prerequisites for a Foreign Feeder Fund to gain traction in Permitted Jurisdictions.

If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney.

[3] For example, the Hong Kong Securities and Futures Commission announced the mutual recognition of funds program between Switzerland and Hong Kong (the "Swiss-HK MRF") in December 2016. The Swiss-HK MRF scheme permits the offering of Swiss funds in Hong Kong, including feeder funds. Hong Kong is a Permitted Jurisdiction, but Switzerland is not.