
Chapter 4

Internationalization and Investment Companies

I. Introduction and Summary of Recommendations

Internationalization is perhaps the most significant development in the United States and world securities markets in recent years. Accelerated by technological advances and the removal of many legal impediments to foreign participation, world markets have become internationalized to an unprecedented degree?

The increased levels of cross-border sales of securities have been fostered in part by and have encouraged regulatory reform. As reported by the Organisation for Economic Co-operation and Development, "[t]here is no other sector within the broad area of the financial services markets in which such a large number of organizational and regulatory changes has taken place as has been the case in the field of securities-related activities."² In the United States, Congress and the Commission have demonstrated a firm commitment to regulatory reform that facilitates internationalization and also maintains investor protection.

As trade, communication, and technological developments have fueled internationalization of the markets generally, they have stimulated interest in investment companies that offer diversified portfolios of foreign securities. Recent global stock market volatility also has heightened interest in these funds.³

¹According to figures compiled by the Commission's Office of Economic Analysis, in 1990, foreign purchases and sales of United States securities were over 20 times higher than they were in 1980, rising from \$198.1 billion to \$4.2 trillion. That same year, United States purchases and sales of foreign securities grew to a level approximately 16 times higher than that in 1980, from \$53.1 billion to \$902.9 billion.

²ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, FINANCIAL MARKET TRENDS 18 (May 1990).

³See Jim Freer, *International Investors Seek Added Diversity*, INT'L BUS. CHRON., Oct. 29 - Nov. 11, 1990, at 16; see also Terry M. Chuppe, Hugh R. Haworth, & Marvin G. Watkins, *The Securities Markets in the 1980s: A Global Perspective* 84-88 (Jan. 26, 1989) (unpublished manuscript, on file with the Securities and Exchange Commission) (citing factors precipitating recent surge in global portfolio investments).

Although investors worldwide appear more eager than ever to diversify their investments with managed portfolios of foreign securities, access by United States investors to foreign investment companies and by foreign investors to United States investment companies generally remains limited. Despite some evidence that cross-border sales of investment company securities are on the rise,⁴ the Division believes cross-border sales do not constitute a significant percentage of total fund sales?

United States investors seeking managed portfolios of foreign investments generally invest in United States-registered funds that concentrate investments in foreign issuers. A growing number of United States-registered investment companies hold foreign securities in their portfolios. For example, the number of United States-registered open-end international equity funds rose from approximately 25 in 1985 to 145 as of December 31, 1991.⁶ The number of United States-registered closed-end "country" funds grew from 3 in 1985 to 33 as of December 31, 1991.⁷

⁴Foreign investors are purchasing more shares of investment companies generally. Reports published by the United States Department of the Treasury on foreign investment in selected United States mutual funds show a nearly 92% increase in the total dollar amount invested by foreign investors from 1978 to 1984 (from \$1,134,000,000 to \$2,173,000,000). DEPT OF THE TREASURY, REPORT ON FOREIGN PORTFOLIO INVESTMENT IN THE UNITED STATES AS OF DEC. 31, 1984, at Table A.8 (1989); DEPT OF THE TREASURY, REPORT ON FOREIGN PORTFOLIO INVESTMENT IN THE UNITED STATES AS OF DEC. 31, 1978, at Table A.3 (1980).

⁵Data on the extent of cross-border sales by foreign investment companies to United States investors or by United States investment companies to foreign investors are limited. The Commission is not able to monitor the nature and extent of foreign investment in United States funds or track United States investment in foreign funds. While the Departments of the Treasury and Commerce and the Board of Governors of the Federal Reserve System collect extensive data concerning cross-border investment, none has comparative data for investment companies. The Department of the Treasury does monitor foreign investment in United States mutual funds, but it provides data on only certain United States investment companies. Although the largest United States investment company industry association, the Investment Company Institute, collects extensive data on the domestic activities of its members, it does not track their overseas activities.

⁶These 145 international equity funds (excluding global funds) held total assets of approximately \$18.5 billion as of December 31, 1991. International equity funds invest their assets mostly in securities whose primary trading markets are outside the United States. LIPPER ANALYTICAL SERVICES, INC., DIRECTORS' ANALYTICAL DATA (1st ed. 1992) [hereinafter DIRECTORS' ANALYTICAL DATA].

⁷These 33 single country funds held total assets of approximately \$4.2 billion as of December 31, 1991. UPPER ANALYTICAL SERVICES, INC., CLOSED-END PERFORMANCE ANALYSIS SERVICE 44 (Jan. 31, 1992). Country funds invest their assets primarily in the securities of issuers domiciled in a particular country or region. In addition, the number of United States global funds (which invest at least 25% of their assets in securities traded outside the United States) rose from 16 as of
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There has been a great deal of debate on how best to increase cross-border sales of investment company shares.⁸ In the European Community, this debate resulted in the European Council Directive of 20th December 1985 on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities ("UCITS Directive").⁹ The UCITS Directive prescribes a common denominator approach to protecting investors in certain open-end investment companies qualifying as UCITS. A UCITS from one European Community Member State

⁷(...continued)

December **31, 1985**, with total assets of **\$6.57** billion, to **71** as of December **31, 1991**, with total assets of **\$18.8** billion. The number of world income funds (which invest in both United States dollar and non-United States dollar debt instruments) grew from **1** as of December **31, 1985**, with total assets of **\$61.2** million, to **88** as of December **31, 1991**, with total assets of **\$29.4** billion. DIRECTORS' ANALYTICAL DATA, *supra* note **6**.

⁸In response to the Commission's request for public comment on cross-border sales, SEC Request for Comments on Reform of the Regulation of Investment Companies, Investment Company Act Release No. **17534** (June 15, **1990**), **55 FR 25322** [hereinafter Study Release], the Commission received comments from the American Bar Association (Section of Business Law); American Council of Life Insurance; Amsterdam Stock Exchange; Banca d'Italia (Italy); Bankers Trust Company; Benham Management Group; Bundesaufsichtsamt für das Kreditwesen (Germany); Calvert Group, Ltd.; Central Bank of Ireland; The Chase Manhattan Bank, N.A.; Citicorp; Cleary, Gottlieb, Steen & Hamilton; République Française, Commission des Opérations de Bourse (France); Commission des valeurs mobilières du Québec; DFA Investment Dimensions Group, Inc. and Dimensional Fund Advisors, Inc.; the Danish Supervisory Authority (Finanstilsynet); Davis Polk & Wardwell; Dechert Price & Rhoads; The Equitable Life Assurance Society of the United States; Federated Investors; the Independent Trustees of the Fidelity Funds; Fidelity Management & Research Company; French Bankers' Association (Association Française des Banques); Timothy J. Gallagher; IDS Financial Services, Inc.; Leslie L. Ogg, Vice President, General Counsel and Treasurer, IDS Mutual Fund Group; Investment Company Institute; the Japanese Government, Ministry of Finance; Howard Kaikow; Linklaters & Paines; Los Angeles County Bar Association, Business and Corporations Law Section (certain committee members); Merrill Lynch & Co., Inc.; Robert G. Miller; Office of the Secretary of State of Missouri; The New York Clearing House Association; North American Securities Administrators Association, Inc.; Prudential Mutual Fund Management, Inc.; The Putnam Companies; Ropes & Gray; Scudder, Stevens & Clark, Inc.; Securities and Investments Board (United Kingdom); Shearson Lehman Brothers Inc.; State Street Bank and Trust Company; Jan Stenbeck, Shareholder and Director of Industriförvaltnings AB Kinnevik; Swedish Bank Inspection Board (Bankinspektionen); Kathleen A. Veach, Mutual Fund Examiner, Ohio Department of Commerce, Division of Securities; Warburg Investment Management International Ltd.; S.G. Warburg & Co., Inc.; Wayne Hummer Growth Fund Trust and Wayne Hummer Money Fund Trust; Westpac Banking Corporation; and the State of Wisconsin (Office of the Commissioner of Securities).

⁹Council Directive **85/611, 1985 O.J. (L 375) 3**.

may sell its shares in any other Member State, subject only to the host country's marketing, advertising, and tax laws.''

In the United States, many in the investment company industry believe that changes in domestic policy are necessary for more receptive treatment of United States funds in foreign countries. The Investment Company Institute ("ICI") has met regularly in recent years with its European counterpart, the European Federation of Investment Companies and Funds. These representatives are working to develop terms for a United States-European Community treaty to facilitate cross-border sales, which the industries propose to present to their respective governments. The topic of cross-border sales of investment company shares also is frequently raised in meetings between the Commission and foreign officials.

There are a number of barriers to cross-border sales of United States investment company shares. For example, to capitalize on the significant investment required in order to reach a large market abroad, United States funds must be able to comply simultaneously with different rules in several countries. In some foreign jurisdictions, United States funds may be subject to more restrictive conditions than are funds organized in those jurisdictions.' Perhaps most importantly, United States funds may find it difficult to break into well-established affiliated distribution networks.¹²

Obviously, only foreign jurisdictions can remove these barriers, but many argue that at least one principal problem for United States funds marketing abroad could be resolved unilaterally by the United States. United States tax law

¹⁰Each Member State must adopt domestic legislation to implement the UCITS Directive, but each is free to choose a form and method of implementation consistent with its legal system. The UCITS Directive generally permits a Member State to impose more stringent requirements on its own UCITS than on other Member States' UCITS sold within its borders.

¹¹For example, in Japan, a foreign investment trust fund may not denominate its securities in yen. *See infra* note 68 and accompanying text. In Germany, foreign funds are subject to higher fees and more complex notification procedures than domestic funds or UCITS. Roland W. Baum and Olivia P. Adler, *Public Distribution of Foreign Mutual Fund Shares in Germany*, 23 *REV. SEC. & COMMODITIES REG.* 223, 225 (1990).

¹²Generally, large investment company complexes with the ability to absorb temporary losses sustained while developing a foreign distribution network cite time, money, and unfavorable United States tax treatment as the primary obstacles, not foreign law. These complexes tend to be less eager than others about changes in regulation to facilitate cross-border sales. Investment company complexes, typically smaller, that do not now operate overseas generally express more enthusiasm about regulatory reform, believing that amending our laws to provide foreign investment companies greater access in the United States will facilitate improved market access for them in other countries.

deters foreign investors from purchasing securities issued by United States investment companies.¹³ Unlike the United States, many foreign countries do not impose distribution and withholding requirements on investment company income.¹⁴ They also tend to impose little if any capital gains tax. These distinctions encourage foreign investors to purchase securities from non-United States investment companies.

From the perspective of a foreign fund seeking to market its securities in the United States, the Investment Company Act¹⁵ presents a formidable challenge. Section 7(d)¹⁶ prohibits a foreign investment company from making a public offering of its shares in the United States through United States jurisdictional means unless the Commission issues an order permitting it to register under the Investment Company Act. Under that section, the Commission must find that "by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions of [the Act] against such company and that the issuance of such order is otherwise consistent with the public interest and the protection of investors."

Congress enacted section 7(d) to enable the Commission to enforce the investor protections of the Investment Company Act against foreign funds operating in the United States.¹⁷ Section 7(d) was intended to ensure the integrity of the United States investment company industry, and effectively provides national treatment for foreign funds registering in the United States. Unfortunately, because foreign regulatory systems for investment companies differ greatly from the Investment Company Act, section 7(d) has operated to limit the entry of foreign funds into the United States market. Because the standard effectively requires a foreign investment company organized in a country with substantially different investment company regulation to structure itself and operate as a United States company, it has proved impossible for most foreign investment companies to meet. In fact, only nineteen foreign funds, most

¹³See, e.g., Letter from The Equitable Life Assurance Society of the United States to Jonathan G. Katz, Secretary, SEC 31 (Oct. 5, 1990), File No. S7-11-90; Letter from Federated Investors to Jonathan G. Katz, Secretary, SEC (Oct. 10, 1990), File No. S7-11-90; and Letter from IDS Financial Services, Inc. to Jonathan G. Katz, Secretary, SEC 28 (Oct. 2, 1990), File No. S7-11-90.

¹⁴See *infra* Section IV.A.

¹⁵Investment Company Act of 1940, 15 U.S.C. § 80a.

¹⁶15 U.S.C. § 80a-7(d).

¹⁷See Commission Policy and Guidelines for Filing of Application for Order Permitting Registration under the Act and Sale of Shares in the United States of Foreign Investment Companies, Investment Company Act Release No. 8959 (Sept. 26, 1975), 40 FR 45424, discussed *infra* notes 26-31 and accompanying text.

from Canada, have ever received orders under section 7(d). The last such order was issued in 1973.¹⁸

Faced with this standard, a foreign investment company may decide to avoid section 7(d) registration requirements by making only a limited United States offering. The Commission has stated that section 7(d) permits a foreign investment company to make a private offering of its securities in the United States without registering, provided that the company has no more than 100 beneficial owners who are United States residents.' Because a foreign investment company may fear the consequences of inadvertently failing to stay within the numerical limit, it might not consider this approach to be a realistic alternative.

A foreign investment company that receives a Commission order under section 7(d) must satisfy another layer of securities regulation in the United States, the "blue sky" laws of those states in which it seeks to offer its securities. Some critics question the merits of state blue sky substantive investment company regulation, considering that the company already would be subject to the extensive investor protections of the Investment Company Act, as well as to its home country investment company regulation.

In view of the opportunities for both United States investors and investment companies if hurdles to cross-border sales are lowered, the Division recommends that the Commission adopt a multi-faceted approach to remove unnecessary barriers to cross-border sales of investment company securities. To promote greater access to foreign markets by United States funds, we recommend that the Commission expand current consultations with foreign fund regulators to increase mutual understanding of investment company regulatory systems. To facilitate access to United States markets by foreign funds and to foreign markets by United States funds, we recommend that section 7(d) of the Investment Company Act be amended to authorize the Commission to enter into bilateral regulatory memoranda of understanding that would create a framework for regulatory cooperation and mutual recognition of investment company regulation. We propose that section 7(d) further be amended to give the Commission greater flexibility to permit foreign funds to register in the United States and to clarify, in the absence of a public offering, when section 7(d) requires foreign funds to register.

¹⁸See *Pan Australian Fund Limited*, Investment Company Act Release Nos. 7795 (Apr. 30, 1973), 38 FR 11141 (Notice of Application) and 8028 (Oct. 10, 1973), 2 SEC Docket 585 (Order).

¹⁹See *Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities under Rules 144 and 145*, Securities Act Release No. 6862, at II.F (Apr. 23, 1990), 55 FR 17933, 17940-41.

The Division also recommends that the Commission continue to work with state securities regulators to coordinate and consolidate substantive regulation while preserving states' significant enforcement responsibilities. Finally, the Division recommends that the competitive disadvantages for United States funds created by the Internal Revenue Code be addressed, although we express no view on specific terms of any amendments to the Code.

This chapter begins with an historical overview of commission attempts to provide a workable standard under section 7(d) for public and private offerings by foreign investment companies. Then follows an explanation of the Division's recommendation to amend section 7(d) to facilitate cross-border sales of investment company securities, maintain investor protection standards, and encourage foreign regulators to provide and facilitate meaningful market access by United States investment companies. The chapter ends with a recommendation that the Commission support generally tax proposals that would enable United States investment companies securing access to foreign markets to compete effectively with foreign funds, and that the Commission continue to work with state securities administrators to eliminate duplicative substantive regulation of investment companies.

II. Background -- Commission Experience with Section 7(d)

The initial Senate version of what became the Investment Company Act absolutely prohibited foreign investment companies from publicly offering their securities in the United States.²⁰ Ultimately, Congress determined that it would be inappropriate to exclude a foreign investment company from United States markets if the Investment Company Act could be enforced against the company and registration would not adversely affect the public interest or investor protection. It enacted a redrafted version of the section, incorporating strict enforceability and public interest provisions.²¹

²⁰*Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 6 (1940) [hereinafter 1940 Senate Hearings].*

²¹Section 7(d) provides:

No investment company, unless organized or otherwise created under the laws of the United States or of a State, and no depositor or trustee of or underwriter for such a company not so organized or created, shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to offer for sale, sell, or deliver after sale, in connection with a public offering, any security of which such company is the issuer. Notwithstanding the provisions of this subsection and of Section 8(a), the Commission is authorized, upon application by an investment company organized or otherwise created under the laws of a foreign country, to issue a conditional or unconditional order permitting

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For the past fifty years, the enforceability standard of section 7(d) has precluded all but a few foreign investment companies from making public offerings in the United States. Section 7(d) theoretically permits foreign funds to register, but practically prevents them from doing so. The Commission has made several unsuccessful attempts to resolve this dilemma.

A. Early Canadian Applications and **Rule 7d-1**

In the early 1950's, four Canadian investment companies applied to the Commission for section 7(d) orders. In reviewing these applications, the Commission considered the circumstances under which the Investment Company Act would apply to the persons or transactions involved and the ability of the Commission and investors effectively to enforce the Act.

In 1954, the Commission adopted rule 7d-1, setting forth the conditions with which Canadian applicants must comply to satisfy the enforceability standard of section 7(d).²² Among other criteria, the rule requires that..

(1) the fund's charter and bylaws contain the substantive provisions of the Investment Company Act, and an interpretation of the charter or bylaws conform with United States law;

(2) each officer, director, adviser, custodian, and underwriter for the investment company enter into an agreement, filed with the Commission, that provides that each will comply with the Investment Company Act, and that the shareholders of the investment company may sue in the United States for any violation of the Investment Company Act;

(3) at least a majority of the directors and officers be United States citizens, a majority of whom will be United States residents;

²¹(...continued)

such company to register under this title and to make a public offering of its securities by use of the mails and means or instrumentalities of interstate commerce, if the Commission finds that, by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions of this title against such company and that the issuance of such order is otherwise consistent with the public interest and the protection of investors.

²²17 C.F.R. § 270.7d-1; Notice of Proposed Rule N-7D-1 Relating to Registration of Management Investment Companies Organized under Canadian Law, Investment Company Act Release No. 1945 (Jan. 28, 1954), 19 FR 754 (proposing rule 7d-1); and Adoption of Rule N-7D-1 Relating to Registration of Management Investment Companies Organized under Canadian Law, Investment Company Act Release No. 1973 (Apr. 27, 1954), 19 FR 2584 (adopting rule 7d-1).

(4) all of the investment company's assets be maintained in the United States with a United States bank;

(5) the original or a duplicate copy of the investment company's books and records be kept in the United States;

(6) the investment company's principal underwriter be a United States entity; and

(7) the investment company use a United States auditor.

Although the rule by its terms applies only to Canadian companies, the Commission also requires non-Canadian foreign investment companies seeking registration orders to comply with the rule's conditions.²³ Because the conditions dictate that a company relying on the rule be structured and operated in large part like a United States investment company, they are impractical for most foreign investment companies.

B. Foreign Portfolio Sales Corporation Act of 1973

In 1973, the Commission proposed amendments to the Investment Company Act to provide special provisions for the registration and regulation of domestic investment companies organized to sell their securities exclusively to foreigners, and to give the Commission greater flexibility to permit foreign investment companies to register under the Act.²⁴ While the proposal would

²³Between 1954 and 1973, the Commission issued section 7(d) orders to investment companies from Canada, Australia, Bermuda, South Africa, and the United Kingdom. *Of* these, only three Canadian funds and the one South African fund remain active. Each of the applicants agreed to comply with the conditions in rule 7d-1 as a prerequisite to receiving its section 7(d) order.

In some instances, the Commission has granted limited exemptive relief from rule 7d-1. For example, in 1979, the Commission permitted a Canadian investment company to maintain its Japanese portfolio securities in the custody of a Japanese branch of a United States bank, which otherwise violated rule 7d-1(b)(8)(v) (providing, among other things, that the company's trustee must maintain sole custody of all of the company's securities and cash in the United States.) See Templeton Growth Fund, Ltd., Investment Company Act Release Nos. 10628 (Mar. 13, 1979), 44 FR 17247 (Notice of Application) and 10657 (Apr. 11, 1979), 17 SEC Docket 280 (Order).

²⁴H.R. 8256, 93d Cong., 1st Sess. (1973). The proposal would have provided for the registration of a new type of investment company that would sell its securities exclusively to foreign investors. The Commission anticipated that the legislation would be accompanied by changes in United States tax law to provide a United States fund that sold exclusively to foreign investors with tax treatment comparable to that available to offshore funds investing in United States securities. This tax treatment would have encouraged offshore funds investing in securities of United States issuers to consider domiciling in the United States. See *also* Offshore Fund (continued..)

have continued to require a Commission determination that it was "both legally and practically feasible effectively to enforce" the provisions of the Investment Company Act against a foreign fund, it also would have authorized the Commission to "take into account the differing laws, regulations, customs, and business conditions of particular countries in which such companies are organized and the adequacy of existing regulation in such countries."²⁵

The proposal was introduced in the House of Representatives, but no further action was taken. In retrospect, it seems probable that even had the amendment become law, it would not have improved the prospects for a foreign fund seeking a section 7(d) order, since it would have retained the strict enforceability language of section 7(d). More likely, the statute would have generated lengthy hearings comparing foreign law and United States law, and invited litigation on the enforceability of the Investment Company Act against a foreign fund.

C. The 1975 Guidelines

In 1975, the Commission issued guidelines for foreign investment companies seeking to register in the United States.²⁶ The 1975 guidelines temper the requirements of rule 7d-1 by providing that foreign investment companies may satisfy the standards of section 7(d) through other means. Since "differences in foreign law applicable to a foreign investment company . . . might prevent compliance with all of the requirements of the [Investment Company] Act,"²⁷ the guidelines state that it may be appropriate for the Commission to grant relief under sections 7(d), 6(c),²⁸ or other sections of the Act. In reviewing registration applications by foreign investment companies, the Commission might "take into account the differing laws, regulations, customs and business conditions of particular countries in which such companies are organized and the adequacy of existing regulation in such countries."²⁹ The protections accorded investors by the regulatory system governing a foreign investment company, however,

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Legislation Proposed by the Securities and Exchange Commission, Investment Company Act Release No. 7751 (Apr. 3, 1973), [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,306 (announcing the submission of the legislative proposal to Congress).

²⁵H.R. 8256, *supra* note 24.

²⁶Inv. Co. Act Rel. 8959, *supra* note 17.

²⁷*Id.* at 1.

²⁸15 U.S.C. § 80a-6(c).

²⁹Inv. Co. Act Rel. 8959, *supra* note 17, at 2.

"should be substantially equivalent to those provisions of the [Investment Company] Act which the Commission determines should be applicable to the foreign investment company."³⁰

The 1975 guidelines, in theory, afford the Commission greater flexibility in interpreting the enforceability standard of section 7(d).³¹ The guidelines, however, have never resulted in a section 7(d) order.

D. The Union-Investment Application

The 1975 guidelines appear in practice to be flawed for much the same reason that the 1973 proposed legislation may have been flawed. Like the legislative proposal, they require the Commission to make detailed findings about the adequacy of foreign law in the narrow context of a specific application, rather than encouraging the Commission to consult directly with foreign regulators in the broader context of determinations on a country-by-country basis.

The Commission's protracted consideration during the 1970's and early 1980's of an application by Union-Investment Gesellschaft m.b.H. ("Union-Investment"), a West German investment management company, on behalf of Unifonds, a West German mutual fund, illustrates this point. The Union-Investment application requested a Commission order under section 6(c) granting exemptions from many provisions of the Investment Company Act, and under section 7(d) permitting registration of Union-Investment, so that it could sell Unifonds shares in the United States.

The Union-Investment application raised a number of novel and difficult issues. For example, Unifonds did not have the legal stature of an entity capable of applying to register under the Investment Company Act. Union-Investment applied on its behalf. In addition, German law prevented Unifonds from agreeing to basic jurisdictional requirements, including consent to jurisdiction of United States courts or appointment of an agent for service of process in the United

³⁰*Id.* at 1.

³¹The guidelines require that a foreign investment company applicant: (1) be a bona fide and established company; (2) be subject to actual regulation by an appropriate foreign governmental authority; (3) not be dependent solely on sales in the United States; (4) be a vehicle for investment primarily in foreign securities; (5) subject itself and its management to service of process; and (6) provide adequate disclosure to investors in the United States. A foreign investment company generally would satisfy these requirements by complying with standards outlined in the release, including that the investment company have minimum net assets of \$50 million, a minimum of 500 shareholders resident in the country in which it is organized, no more than 50% of its shares sold to United States investors, and a minimum of either 60% of the value of its portfolio invested in issuers in the country in which it is organized or 75% in non-United States issuers. *Id.* at 2.

States.³² Furthermore, Union-Investment was unable or unwilling to comply with the Investment Company Act in a number of significant respects (*e.g.*, affiliated transactions, disinterested directors, and voting shareholders).

Nonetheless, the Commission published a notice of the application in 1982.³³ In 1983, after the ICI requested a hearing on the application,³⁴ Union-Investment announced that it could no longer bear the time and expense involved in continuing to pursue its registration and exemptive requests, and withdrew its application.

E. The "Mirror Funds" Release

The Union-Investment application demonstrated that, notwithstanding the 1975 guidelines, a foreign investment company still may have difficulty meeting section 7(d)'s enforceability standards. In December 1983, following Union-Investment's withdrawal, the Commission issued a release advising any prospective foreign investment company applicant subject to laws conflicting irreconcilably with the Investment Company Act to consider forming a "mirror" fund to offer its securities in the United States.³⁵ By organizing a United States

³²*See, e.g.*, 17 C.F.R. § 270.7d-1(b)(1), (b)(2), (b)(2), (b)(6), (b)(8). Union-Investment had consented to United States jurisdiction and to the appointment of an agent for service of process in the United States. It also undertook to secure an irrevocable letter of credit, initially in the amount of \$1 million, to be increased to an amount equaling five percent of Unifonds shares actually sold in the United States, to be available to pay damages to any person obtaining a United States judgment against Union-Investment for violating United States securities laws.

These conditions, however, could not ensure the Commission's ability to investigate possible cases of United States securities law violations or to bring a criminal action or enforce an injunction against Unifonds, its distributor, custodian, or accountant, or against the officers of Union-Investment. Union-Investment represented that it would have been inconsistent with West German business practices for these parties to have agreed to comply with the terms of the Investment Company Act, waive their immunity from personal liability to United States shareholders, consent to jurisdiction of United States courts, and appoint an agent for service of process in the United States. Moreover, neither Unifonds nor Union-Investment would have maintained duplicate books or records in the United States, and German law prohibited Union-Investment from permitting Commission staff to inspect books and records in Germany.

³³Union-Investment-Gesellschaft m.b.H., Investment Company Act Release No. 12863 (Dec. 1, 1982), 47 FR 57179 (Notice of Application).

³⁴Union-Investment-Gesellschaft m.b.H.; Hearing on Application for an Order Permitting Registration of an Investment Company Organized in West Germany and Granting Exemptions, Investment Company Act Release No. 13234A (May 17, 1983), 48 FR 23342.

³⁵Applications of Foreign Investment Companies Filed Pursuant to Section 7(d) of the Investment Company Act of 1940, Investment Company Act Release No. 13691 (Dec. 23, 1983), 49 FR 55.

investment company investing primarily in the securities of foreign issuers, a foreign money manager would be able to offer its services to United States investors without needing to register the foreign investment company under section 7(d).³⁶ The newly-created United States fund could "mirror" the investments of any of the foreign money manager's foreign funds. The Commission emphasized that this approach was not based on the merits of foreign regulatory systems as compared to the United States system, but rather on the reality that, unless section 7(d) was amended, a mirror fund was a more feasible and less costly alternative to registration.³⁷

The mirror fund alternative has the advantage of avoiding section 7(d) determinations about the adequacy of foreign law and investor protection under that law. Judging from the registration of foreign-based advisers and subadvisers, mirror funds may comprise a significant portion of the growing number of United States companies investing in foreign securities?'

The mirror fund approach, however, is of limited practicality in an increasingly international securities market. It is a burdensome and expensive option for foreign investment companies. As a separate company, a mirror fund loses the ability to promote its securities in the United States based on any previous successful history of the overseas investment company,³⁹ and cannot realize certain economies of scale. The investing public ultimately bears the additional costs. The mirror fund solution does little to improve United States investment company access abroad.

³⁶Of course, the "mirror" fund would need to register under section 8 of the Investment Company Act (15 U.S.C. § 80a-8).

³⁷Inv. Co. Act. Rel. 13691, *supra* note 35.

³⁸As of September 1988, 165 foreign investment advisers representing 27 countries had registered in the United States; by March 1992, 269 foreign advisers representing 36 countries had registered. A significant number of the United States registered investment companies advised by these foreign advisers may be mirror funds. See, e.g., The Japan OTC Equity Fund, Inc. (Registration No. 811-5992), advised by Nomura Investment Management; The Germany Fund (Registration No. 811-4632), advised by DB Capital Management International (Deutsche Bank); and The First Australia Fund (Registration No. 811-4438), advised by EquitiLink Australia Ltd.

³⁹See 17 C.F.R. § 230.482(e); Advertising by Investment Companies, Investment Company Act Release No. 16245 at n.31 (Feb. 2, 1988), 53 FR 3868 (adopting advertising rules).

F. The Foreign Investment Company Amendments Act of 1984

One month after issuing the mirror funds release, the Commission proposed the Foreign Investment Company Act Amendments of 1984.⁴⁰ The Commission observed that section 7(d) had operated to prevent foreign investment companies from registering under the Investment Company Act and offering shares in the United States, which, in turn, led to "needless costs and insurmountable barriers to foreign companies seeking access to United States markets, lost competitive opportunities, and a denial of investment opportunities for United States investors."⁴¹ The proposed legislation would have given the Commission greater flexibility to recognize differences among regulatory systems and "to fashion workable regulatory approaches for companies doing business internationally without sacrificing investor protection."⁴²

The proposal would have retained the present language of section 7(d), but also would have authorized the Commission to exempt an operating foreign investment company from any provision of the Investment Company Act, provided that: (1) compliance with the provision would be unduly burdensome because the company was organized or otherwise created under foreign law and invested primarily in foreign securities; (2) either the laws under which the company operated provided protections for investors that served the same purposes as the protections provided by the provisions of the Investment Company Act from which exemption was requested, or specific conditions agreed to by the company provided such protections; (3) an exemption was consistent with the protection of investors and the purposes fairly intended by the policies of the Investment Company Act; and (4) the company was not operated for the purpose of evading the provisions of the Investment Company Act. By broadening the Commission's authority to grant exemptions, the proposal would have relaxed significantly the enforceability standard of section 7(d).

The proposal included a number of important safeguards. It would have applied only to operating foreign investment companies. An operating foreign investment company was defined as a company, organized or created under the laws of a foreign country, that had been in operation with a minimum of 500 non-United States shareholders and \$100 million in net assets for at least three years,

⁴⁰Letter from John S.R. Shad, Chairman, United States Securities and Exchange Commission, to Thomas P. O'Neill, Jr., Speaker of the United States House of Representatives (Jan. 31, 1984) (transmitting proposal to amend section 7(d)).

⁴¹Memorandum of the Securities and Exchange Commission in Support of the Foreign Investment Company Amendments Act of 1984, at 1 (Jan. 31, 1984) (accompanying proposal to amend section 7(d)).

⁴²*Id.* at 3.

and that was primarily engaged in investing in the securities of non-United States issuers.⁴³ This requirement was intended to deter United States investment company sponsors from moving offshore to a jurisdiction with differing regulation and seeking a section 7(d) order.⁴⁴

The Commission's proposal never was introduced in Congress. Critics argue that it would have offered foreign investment companies a competitive advantage in the United States. They maintain that for many foreign investment companies, the costs of complying with the laws of their home countries are lower than those incurred by United States investment companies complying with United States securities laws.⁴⁵ They also charge that the proposal did not address the barriers that United States investment companies face when offering their shares abroad. Arguing that foreign laws imposing stricter licensing and other requirements on non-domestic investment companies have greatly limited the marketing of United States investment company shares overseas, industry representatives generally favor amendments that would permit the Commission to consider reciprocity as a factor in determining whether to issue an order permitting registration of a foreign fund.⁴⁶

Furthermore, the 1984 proposal again would have required the Commission to make difficult determinations about the adequacy of foreign law compared with United States law in the context of a specific application. In addition to the problems identified in the course of the Union-Investment application, gaps between foreign law as written and as practiced would make it difficult for the Commission to make these findings. Moreover, making these determinations in the context of individual applications could result in inappropriate precedent. Given variations in size, reputation, practice, and success among foreign investment companies from the same country, the process

⁴³*Id.* at 5. Foreign funds that did not meet the definition would have remained subject to the original section 7(d) standards.

⁴⁴The proposal also provided that any section 7(d) order could be revoked or modified if the circumstances upon which the order were based had changed. This could occur, for example, if the applicable provisions of the Investment Company Act could no longer be enforced against the company, the regulatory system upon which the Commission's determination was based no longer provided sufficient investor protections, or if the foreign company no longer was engaged primarily in investing in securities of non-United States issuers. *Id.*

⁴⁵See Letter from Davis, Polk & Wardwell to Jonathan G. Katz, Secretary, SEC 20 (Oct. 10, 1990), File No. S7-11-90 (summarizing critics' objections) [hereinafter Davis Polk **Study** Comment].

⁴⁶See *id.*; Letter from Investment Company Institute to Jonathan G. Katz, Secretary, SEC 65-66 (Oct. 5, 1990), File No. S7-11-90; and Letter from Prudential Mutual Fund Management, Inc. to Jonathan G. Katz, Secretary, SEC 8 (Oct. 9, 1990), File No. S7-11-90.

could have resulted in the development of application standards that would have been unsuitable for other investment companies from even the same country.

G. Section 7(d) and Private Offerings

Section 7(d) is the only section of the Act directed specifically to foreign investment companies. While section 7(d) prohibits a foreign fund from making a *public* offering of its securities in the United States without obtaining a Commission order permitting it to register under the Investment Company Act, it does not expressly prohibit private offerings or limit the number of shareholders that a foreign fund may have.⁴⁷

Section 3(c)(1) of the Investment Company Act addresses offerings by private investment companies: ' It excepts from the definition of investment company an entity that has no more than 100 beneficial owners of its securities and that does not presently propose to make a public offering of its securities. As discussed in Chapter 2, Congress determined that the point at which an investment company has more than 100 owners reasonably reflects when public interest concerns arise.

If an entity does not qualify for the section 3(c)(1) exception and is otherwise an investment company as defined in the Act, it must look to section 7 for its registration obligation. Section 7(a) prohibits a domestic fund from making any offering of its securities without Investment Company Act registration. In contrast, by its terms, section 7(d) only prohibits an unregistered foreign fund from making a *public* offering in the United States.

The Commission, through interpretation of the statute, has married section 7(d) to section 3(c)(1). In 1984, the Division stated that an unregistered foreign fund could make a private offering in the United States concurrently with a public offering abroad and not violate section 7(d), provided the fund had no

⁴⁷Congress, in the legislative history of section 7(d), did not distinguish between public and private offerings by foreign investment companies. See 1940 *Senate Hearings, supra* note 20, at 196-97 (statement of David Schenker, Counsel for the Investment Trust Study, Securities and Exchange Commission); S. REP. No. 1775, 76th Cong., 3d Sess. 13 (1940).

⁴⁸15 U.S.C. § 80a-3(c)(1).

more than 100 beneficial owners resident in the United States.⁴⁹ In 1990, the Commission endorsed that position in its release adopting rule 144A.⁵⁰

Critics of the Commission's position charge that it lacks a statutory basis. They argue that Congress intended section 7(d) to restrict only *public* offerings by foreign investment companies, and stress that section 7(d) does not contain any shareholder limit comparable to that found in section 3(c)(1). They also point out that the Commission's position creates competitive problems for foreign funds.⁵¹

For example, certain foreign central depository systems like Euro-Clear and CEDEL (Central de Livraison Valeurs Mobilières) do not provide for constant monitoring of the nationalities of purchasers. Consequently, the Commission's position compels foreign funds considering United States offerings to include charter provisions permitting forced transfers, purchases, or denials of ownership registration whenever the number of United States residential owners exceeds 100. These procedures are quite costly and burdensome.⁵² Further, because it is difficult to track ownership of United States residents, foreign funds may inadvertently exceed the 100 United States resident limit. Fear of inadvertent

⁴⁹Touche Remnant (pub. avail. Aug. 27, 1984). The position that the private offering need not be integrated with the public offering is consistent with Regulation D under the Securities Act of 1933 (17 C.F.R. §§ 230.501 - .508 (1991)). Preliminary Note 7 to Regulation D states that an issuer may make a private placement in the United States in accordance with Regulation D concurrently with an offering abroad in accordance with Regulation S under the Securities Act (17 C.F.R. §§ 230.901 - .904) without integrating the two offerings.

⁵⁰The release stated:

The Commission believes that resales of privately placed investment company securities pursuant to the safe harbor provisions of Rule 144A would not cause the issuing investment company to lose the exemption provided by section 3(c)(1) or **cause a** violation of section 7(d) of the Investment Company Act as long as after the resale the securities are held, for purposes of section 3(c)(1), by no more than 100 beneficial owners or, for purposes of section 7(d), by no more than 100 beneficial owners who are U.S. residents Rule 144A will not obviate the obligation of . . . a foreign investment company [] to apply for an exemptive order permitting it to register [] under the Investment Company Act if . . . there will be more than 100 U.S. residents who are beneficial owners of its securities.

Sec. Act Rel. 6862, *supra* note 19, at II.F.

⁵¹*See, e.g.*, Letter from Cleary, Gottlieb, Steen & Hamilton to Jonathan G. Katz, Secretary, SEC 30 (Oct. 12, 1990), File No. S7-11-90.

⁵²*See, e.g.*, Davis Polk Study Comment, *supra* note 45, at 16-17.

violations may cause foreign funds to forego completely offering their securities in the United States.

Section 7(d) is intended to protect United States investors by subjecting foreign and domestic investment companies to similar standards. The Commission's position does prevent foreign funds from circumventing the point at which a valid United States regulatory interest arises and from enjoying an unfair advantage over domestic funds. Therefore, the effects of the position plus the absence of language in section 7(d) specifically addressing non-public offerings by foreign investment companies warrant statutory clarification.

111. Discussion -- Removing Unnecessary Barriers to Cross-Border Sales

The Division analyzed a number of approaches to overcoming the barriers created by section 7(d), including: more expansive use of the Commission's exemptive and rulemaking authority; harmonization of United States and foreign law; pursuit of treaties that would override section 7(d); and amending section 7(d) to give the Commission more flexibility in permitting foreign funds to register under the Investment Company Act.

The Commission has tried repeatedly to use its authority within the strictures of section 7(d). Further expanding the Commission's use of existing authority would disregard the strict limitations that section 7(d) places on the Commission's flexibility, as demonstrated by the history of the Union-Investment application, and, as such, is unworkable. Accordingly, we do not recommend it. Harmonization and treaty negotiations have merit, but, as discussed below, both approaches have significant drawbacks and are not substitutes for an amendment of section 7(d). Only the third approach, statutory amendment, promises both to offer greater access by United States funds to foreign markets and to maintain an effective and efficient means of regulation. Under our proposal, section 7(d) would be amended to provide the flexibility needed to permit foreign funds to register under the Investment Company Act and encourage foreign regulators to ease regulatory restrictions on United States funds abroad.

A. Harmonization

Harmonizing the provisions of the Investment Company Act with standards provided under foreign law⁵³ would assure equality of investor

⁵³"Harmonization" refers to the achievement of substantially identical regulatory regimes or common regulatory requirements. It should be distinguished from "mutual recognition," which means two or more jurisdictions have regulation following the same basic principles and **each** generally accepts compliance with the others' rules within its own jurisdiction.

protection and the elimination of competitive disadvantages, provided each jurisdiction interpreted and enforced its laws similarly. The differences between the regulatory systems of foreign countries and the United States are so vast, however, that harmonization is unlikely in the foreseeable future.

Many foreign investment company regulatory systems are driven by fundamentally different philosophical underpinnings from those underlying the United States system. For example, Japan and many of the Member States in the European Community rely on licensing or authorization procedures to restrict market entrance to only "fit and proper" applicants. In contrast, in the United States, any person may sponsor an investment company provided it has the necessary seed money of \$100,000 and is not subject to a statutory disqualification. While some may view the vetting system as unduly paternalistic and subject to abuse and favoritism, foreign regulators may view the more open system of the United States as inordinately risky.

Further, many of the regulatory provisions that Congress and the Commission have deemed essential to investor protection simply do not exist abroad. For example, the European Community's UCITS Directive does not prohibit backward pricing of fund shares; United States regulation under the Investment Company Act requires forward pricing to avoid manipulative practices.⁵⁴ Similarly, most European Community Member States do not prohibit transactions between a fund and an affiliate; in the United States, the prohibition against affiliated transactions is a cornerstone of the Investment Company Act.⁵⁵ Such widespread differences among countries suggest that harmonization is unlikely in the foreseeable future.

Because complete harmonization is unlikely, some industry representatives have suggested a more limited approach. They propose an amendment of the Investment Company Act to authorize an alternate collective investment vehicle, the unitary investment fund ("UIF"). They argue that the UIF would be a new type of United States investment company that would resemble more closely the structure of investment companies in the European Community and Japan.

As discussed in Chapter 7, the Division has analyzed the UIF. We conclude that, while the governance requirements of the Investment Company Act may be improved, they are generally efficient and should not be replaced. In addition, the Division does not believe that the UIF would resolve section 7(d)

⁵⁴See Chapter 8.

⁵⁵Many Member States apparently rely on an investment company's depository to prevent abuses that may arise from affiliated transactions, even though the depository is itself an affiliate of the investment company.

issues. Despite the UIFs structural similarity to investment vehicles in other countries, it would not address the significant differences in regulatory approaches to other investor protection issues, such as the treatment of affiliated transactions and pricing methods.

B. Treaties

Mutual recognition through treaties is another possible route for achieving cross-border sales of investment management services. The pursuit of treaties with other countries is the most obvious and often recommended mutual recognition approach. A treaty would supersede the current enforceability standard of section 7(d).

A treaty between two countries, such as the United States and Canada, for example, might provide that shares of investment companies from either country could be traded freely in the other country, subject to some general guidelines. For instance, the treaty might provide that the country of domicile would regulate the fund's structure and operations, while each country would regulate marketing within its borders (an approach taken by the UCITS Directive). Presumably, either country could include in the treaty any additional conditions it believed necessary in order to permit entry by a foreign fund.

In light of the UCITS Directive, many have suggested that the European Community should be the United States' first treaty partner. The UCITS Directive allows cross-border sales within the European Community of UCITS, which resemble United States open-end funds. The development of a European Community-wide market for UCITS has raised hopes for a United States-European Community treaty that would allow any UCITS qualified in a Member State to register in the United States, and would allow United States investment companies to register in one and market in all twelve of the Member States.

The United States and European investment company industries already have attempted to lay the groundwork for this type of treaty. In recent years, the Investment Company Institute has met with its European counterpart to discuss the possibility of a reciprocal agreement along these lines. Representatives of both groups have met with Division staff to discuss the possibility of an agreement.

The Division believes that treaty negotiations are a useful alternative and should not be discounted. One major advantage of the treaty approach is that it allows the United States to determine, based on investor protection standards, which country or group of countries would be appropriate treaty partners; only funds from those countries would be affected.

The treaty alternative may not be the most effective approach, however, because it may not give the Commission as much flexibility as would a legislative amendment of section 7(d). Should the foreign operation or regulation of a foreign fund registered in the United States materially change, amending a treaty likely would be much more difficult than amending a Commission rule or order under a revised section 7(d).

C. Recommendation -- Amendment of Section 7(d)

The third approach, and the one the Division recommends, is a modified version of the Commission's 1984 legislative proposal. That proposal would have authorized the Commission to grant, by rule or order, permission to an "operating foreign investment company" to register under the Investment Company Act and to exempt it from one or more of the provisions of the Act if the Commission found that: compliance with the Act would be unduly burdensome, given the nature of the company; either the laws under which the company operates provide protections to investors that serve the same purposes as the provisions of the Act from which exemption is requested, or that specific conditions agreed to by the company provide these protections; an exemption is consistent with investor protection and the policies of the Act; and the company is not operated for the purpose of evading the provisions of the Act.⁵⁶

Our proposal introduces five changes to the 1984 standards.⁵⁷ Our proposal also would address activities of investment companies that have not made a public offering in the United States, but have taken active steps to promote the sale of their securities to United States residents. The proposed amendment to section 7(d) would require a foreign investment company to register if it uses United States jurisdictional means in connection with any United States offering of its securities and has more than 100 shareholders of record who are United States residents. Similarly, a foreign investment company would be subject to section 7(d) if it has taken steps to facilitate secondary market trading in its securities by, among other things, listing its shares on a securities exchange or having its shares quoted in an over-the-counter market in the United States, and has more than 100 shareholders of record who are United States residents.

⁵⁶See *supra* Section II.F.

⁵⁷The full text of our proposal is set forth in Appendix 4-A which appears at the end of this chapter.

1. Necessary or Appropriate

The Division's proposal would substitute a "necessary or appropriate in the public interest" standard for the 1984 proposal's "unduly burdensome" determination. This change would make the proposed language consistent with the standard of section 6(c).⁵⁸ Arguably, an "unduly burdensome" standard is a lower standard than domestic investment companies must meet in order to receive an exemption from a provision of the Investment Company Act. Domestic funds must demonstrate a requested exemption is necessary and appropriate in the public interest; the 1984 proposal would have required foreign funds to demonstrate that compliance would be merely too onerous.

2. Adequacy of Foreign Law -- Mutual Recognition

Like the 1984 proposal, the Division's proposal would require the Commission to find that the foreign law under which a fund operates or specific conditions agreed to by the applicant provide protections for investors that serve the same purposes as the protections under provisions of the Investment Company Act from which the fund requests exemption. Of course, the protections provided by the foreign regulatory system need not be identical to the Investment Company Act provisions from which exemption is requested. Rather, the Commission need find that the foreign law adequately addresses the same regulatory concerns and serves essentially the same purposes, and that the exemption is consistent with the protection of investors and the purposes fairly intended by the Investment Company Act. In making that finding, the Commission could consider the different regulatory requirements, customs, investment company business practices, and overall investment company regulatory framework in the jurisdiction in which the fund is organized.⁵⁹

⁵⁸Under section 6(c), the Commission must find that a proposed exemption is "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

⁵⁹For example, some foreign regulatory systems permit backward pricing and affiliated transactions. See *supra* notes 54-55 and accompanying text. Although prohibitions against backward pricing and certain affiliated transactions are cornerstones of the Investment Company Act, the Commission might determine that other protections afforded by those systems appropriately could substitute for the Act's prohibitions. Although we would not expect that the Commission would deny a request for a section 7(d) order merely because a regulatory system permitted affiliated transactions, it **would** be critical for the Commission to determine that the system protected fund investors against harm from such transactions. For instance, in the case of foreign funds operating under the UCITS Directive, the Commission might look at whether customary business practices in the European Community and monitoring by the depositary could serve the same purposes as provisions under section 17.

The Division anticipates that it will be difficult to make detailed findings about the adequacy of foreign law, particularly if there exists a gap between the law as written and as actually practiced. To address this concern, the Division's proposal would require the Commission, prior to acting on applications for section 7(d) orders, to enter into bilateral regulatory memoranda of understanding with the securities authorities in countries with regulatory regimes providing the same type and quality of investor protection as provided by the Investment Company Act. The memorandum would set forth representations about the nature and extent of foreign regulation. Negotiating special memoranda of understanding with the appropriate foreign regulators would give the Commission the advantage of learning from the foreign regulators, rather than the applicants, the manner in which foreign law is interpreted and enforced, and would eliminate the need for extensive discussions with the applicants about how they are regulated!

In addition, the memoranda would create a framework for regulatory cooperation and mutual recognition of investment company regulatory practices. They would establish the basis not only for exempting a foreign investment company from regulation under the Investment Company Act, but also for allowing United States funds to satisfy foreign regulatory requirements to the degree necessary to provide them complementary access into foreign countries!

One of the principal criticisms of the 1984 proposal is that it failed to address barriers that United States companies face when offering shares abroad. Although investment company laws in some of the largest investment company markets outside the United States -- the United Kingdom, Germany, and Japan -- currently permit foreign investment companies to make public offerings of securities within their borders, differing legal standards and onerous regulatory requirements continue to make foreign registration problematic, if not impossible, for many United States investment companies.

For example, in the United Kingdom, United States investment companies face problems not unlike those created by section 7(d) for foreign funds. Section 87 of the Financial Services Act provides for registration of foreign investment companies from a country whose laws will protect investors in the United

⁶⁰Memoranda of understanding also would assist the Commission in reviewing the operations of United States investment companies registered and operating abroad. Agreements could help the Commission better understand foreign regulation of United States funds.

⁶¹*Cf.* H.R. 1347, 102d Cong., 1st Sess. (1991); S. 347, 102d Cong., 1st Sess. (1991) (as passed by the Senate) (a recent legislative initiative that would authorize the Commission to deny broker-dealer and investment adviser registration to a foreign company if the company's home country denies United States broker-dealers and investment advisers national treatment). The Commission took no position on this initiative.

Kingdom at least to the extent to which investors are protected in authorized United Kingdom trusts.⁶² The Isle of Man, Jersey, Guernsey, and Bermuda have been able to meet the standards in section 87; however, each jurisdiction changed its laws to make them nearly identical to those of the United Kingdom. Investment companies from the United States likely would have difficulty qualifying under section 87.⁶³

United States investment companies more readily qualify to register under the statutes and regulations of countries such as Germany and Japan. In these countries, however, marketing and procedural hurdles restrict access by United States funds to foreign investors.

German law generally accommodates foreign investment companies not comporting with typical German investment company structures or relationships.⁶⁴ A United States investment company still may have difficulty breaking into the German investment company distribution network, however, because German banking and insurance companies marketing their own investment company securities dominate the market.⁶⁵

Application of Japanese regulations appears to reduce the competitive ability of United States investment companies in other ways. United States and other foreign open-end investment trust funds may offer shares publicly if they meet the requirements of the "Standard Rules for the Selection of Foreign Investment Trust Funds to be Sold in Japan" of the Japan Securities Dealers

⁶²Financial Services Act, 1986, Ch. 8, § 87 (Eng.).

⁶³Section 88, the other applicable provision in the Financial Services Act, is also problematic since that provision requires, among other things, that persons connected with the control and operation of the investment company be "fit and proper." *Id.* at Ch. 8, § 88. The Investment Company Act does not have a similar standard.

⁶⁴For example, custodians of foreign investment companies need not perform exactly as custodians for German funds if investors are assured of security comparable to that provided under German domestic investment company law. Baum and Adler, *supra* note 11, at 227.

⁶⁵*Id.* at 228. A few United States investment company complexes, including Pioneer and Templeton, have succeeded in developing distribution networks in Germany. As of July 1990, Pioneer had annual sales of \$150 million of its United States funds in West Germany. *Pioneer to Skip UCIT Route and Sell Own Funds in Europe*, FUND ACTION, July 9, 1990, at 7. Apparently, the United States tax treaty with Germany (reducing the withholding tax rate from 30% to 15%) and the credit Germany allows for payment of the United States withholding tax sufficiently reduce the United States tax burden for German investors.

Association.⁶⁶ While these rules may seem relatively easy for United States and other foreign investment companies to satisfy, United States industry representatives state that **other Japanese** regulations severely impede United States market access and success.⁶⁷ For example, they prohibit United States and other foreign investment companies from denominating their securities in yen, and Japanese investors are generally reluctant to invest in foreign currency-denominated funds.⁶⁸ They also prohibit direct marketing of foreign fund shares, making it difficult for foreign government securities funds to develop a sales network for their products.

These types of market constraints led the opponents of the 1984 proposal to argue that foreign funds should not be allowed to register in the United States unless United States funds receive reciprocal treatment abroad. The Division believes that the memorandum of understanding approach to mutual recognition meets these concerns because, by resolving prudential and jurisdictional issues, the memoranda themselves would provide a mandate for bilateral access to each country's market.

In addition, a memorandum of understanding procedure would be a practical means of addressing compliance and enforcement issues. Under the Division's proposal, exemptions from the Investment Company Act for foreign funds will be based on a determination that the applicable foreign law is an adequate substitute. Accordingly, the appropriate foreign regulator in each case would be in the best position to assess compliance concerns under its own law. Following a memorandum of understanding procedure, the Commission would

⁶⁶THE INVESTMENT TRUSTS ASSOCIATION, INVESTMENT TRUSTS IN JAPAN 52 (1990). The Investment Trusts Association is the only authorized self-regulatory body of investment trust funds in Japan.

⁶⁷Foreign investment managers have found it very difficult to secure licenses to manage investment trust funds in Japan. Until December 1989, Japanese law absolutely prohibited foreign firms from engaging in investment trust management in Japan. Today, although it may receive a license, a foreign management company must satisfy burdensome standards regarding capital, distribution, and administration. For example, Fidelity Investments, the only United States company that has received a license to manage a yen-denominated fund for Japanese investors, has not yet begun operations. Fidelity cites several reasons for the delay, including a capital requirement of \$7 to \$8 million to manage the fund, the need for an additional license to distribute fund shares (entailing another large capital contribution), and a requirement that foreign fund managers utilize 30 Japanese employees to support back office operations. Letter from Robert C. Pozen, General Counsel, Fidelity Investments, to Marianne Smythe, Director, Division of Investment Management, SEC (June 7, 1991) (expressing concerns about improving access by foreign investment companies to United States markets without simultaneously securing greater access for United States investment companies abroad).

⁶⁸*Managing Money: A Legal Guide to the World's Investment Fund Markets*, INT'L FIN. L. REV. 109 (Special Supp. Apr. 1990).

agree with foreign regulators as to how to enforce investor protections.⁶⁹ In an extreme case where foreign or United States methods of enforcement would prove inadequate, the Commission would have authority to revoke the registration order of the foreign fund. To the extent foreign regulators are unable to address a violation in the first instance, memoranda of understanding would provide mutually acceptable standards for cooperative enforcement efforts.⁷⁰

The Division's proposal would increase the Commission's flexibility by expressly authorizing it to issue rules as well as orders in connection with registering operating foreign investment companies. In contrast to registration and exemptive orders, rulemaking would permit the Commission to take advantage of a country-by-country approach. Once the Commission negotiates a regulatory memorandum recognizing that a particular jurisdiction's regulatory system sufficiently protects fund investors and creating a framework for regulatory cooperation and mutual recognition of investment company regulation, a Commission rule would enable any investment company regulated under that system and complying with the terms of the rule to register under section 7(d).

3. Operating Foreign Investment Company

The amendment, like the 1984 proposal, also would allow the Commission to deny a request for an order by an investment company seeking to circumvent the Investment Company Act. Obviously, an amended section 7(d) should not provide a means of access to United States investors by newly created foreign shell investment companies, or an incentive for United States funds to reorganize in a jurisdiction with more permissive regulation and receive section 7(d) orders permitting public offerings in the United States. By limiting section 7(d) orders to funds qualifying as "operating foreign investment companies," and requiring that an applicant not be operated for the purposes of evading the provisions of the Investment Company Act, the Commission in the 1984 proposal intended that only a *bonafide* foreign investment company with an established operating history could avail itself of the more flexible section 7(d) provisions. The 1984 proposal

⁶⁹Relying on memoranda of understanding is conceptually consistent with the Division's premise for amending section 7(d); namely, that the Commission may rely upon foreign regulation to provide protections serving the same purposes as those afforded under the Investment Company Act. If the Commission determines it may rely on foreign law in place of Investment Company Act requirements, it must also determine that the foreign law and regulators provide means for United States investors and the Commission to enforce foreign law. Memoranda of understanding could permit the Commission to determine whether United States investors in practice would have meaningful access to remedies under foreign law and the extent to which the Commission appropriately should require consent to United States jurisdiction and to the appointment of an agent for service of process.

⁷⁰In no case should the proposed memoranda of understanding process affect the Commission's ability to enforce the fraud-related provisions of United States securities laws.

would have defined an operating foreign investment company as a company that: (1) was organized or created under the laws of a foreign country; (2) had been in operation, with a minimum of 500 non-United States shareholders and \$100 million in net assets, for a period of three years or more; and (3) was primarily engaged in investing in the securities of non-United States issuers.

The Division recommends retaining the 1984 definition, with one important modification. To give the Commission necessary flexibility, the legislation should authorize the Commission to establish, by rule or order, the minimum assets under management, number of non-United States shareholders, and years in operation.⁷¹

4. Commission Authority to Rescind Section 7(d) Orders

The 1984 proposal would have authorized the Commission to rescind a section 7(d) order under circumstances suggesting that the order was not serving its intended purpose.⁷² The Division's proposal deletes this authorization

⁷¹The Division considered whether it might be more appropriate to use the analogous definitions of "foreign issuer" or "foreign private issuer" in rules and regulations under the Securities Act (15 U.S.C. §§ 77a-77aa) and the Securities Exchange Act (15 U.S.C. §§ 78a-78ll). Under the Exchange Act, "[t]he term 'foreign issuer' means any issuer which is a foreign government, a national of any foreign country or a corporation or other organization incorporated or organized under the laws of any foreign country." 17 C.F.R. § 240.3b-4(b); see also 17 C.F.R. § 230.902(f) (definition of "foreign issuer" under Regulation S of the Securities Act). "Foreign private issuer" under both acts

means any foreign issuer other than a foreign government except an issuer meeting the following conditions: (1) more than 50 percent of the outstanding voting securities of such issuer are held of record either directly or through voting trust certificates or depositary receipts by residents of the United States; and (2) any of the following: (i) the majority of the executive officers or directors are United States citizens or residents; (ii) more than 50 percent of the assets of the issuer are located in the United States; or (iii) the business of the issuer is administered principally in the United States.

17 C.F.R. §§ 230.405 and 240.3b-4(c). These definitions are intended to prevent foreign issuers generally owned and managed by United States persons from taking advantage of exemptions or forms available to other issuers organized under foreign law.

None of these definitions includes tests for minimum asset levels, number of non-United States shareholders, or operating history. As such, they do not address a primary concern under section 7(d) -- avoiding the United States sale of shares of foreign investment companies that are shells.

⁷²The proposal would have authorized the Commission to revoke or modify any order **issued** under section 7(d) if it found: (1) that it was not legally or practically feasible effectively to
(continued..)

because section 38(a) specifically grants the Commission the authority to rescind or amend orders.⁷³ The Division sees no reason to include special standards for rescission within section 7(d).

5. Non-Public Offerings

The proposed amendment would include language to address when the Investment Company Act requires registration by foreign funds actively promoting the sale of their securities to United States residents in other than public offerings. Because it is difficult overseas to track United States resident ownership, a foreign fund should not be required to make determinations as to whether there are more than 100 United States residents who beneficially own its securities.⁷⁴ Because a continuous monitoring requirement is appropriate, however, a foreign fund should be required to monitor its shareholders of record.

Accordingly, the proposal would require a foreign fund not otherwise excepted from the definition of an investment company to register if it makes a public offer using United States jurisdictional means; it has used United States jurisdictional means in connection with any United States offering of its securities and has more than 100 shareholders of record who are United States residents; or it has taken steps to facilitate secondary market trading in its securities in the United States either by listing its shares on a securities exchange or having its shares quoted by any securities processor registered under the Exchange Act or by other means, and has more than 100 shareholders of record who are United States residents. The first of these circumstances reflects a foreign fund's registration obligation as currently provided under section 7(d); the second clarifies the language of the statute to reflect expressly the Commission's position in the release adopting rule 144A; and the third sets forth the remaining circumstances under which a foreign investment company may incur a registration obligation under the Investment Company Act.

⁷²(...continued)

enforce the provisions of the Investment Company Act to which the fund was subject; (2) that the fund was not primarily investing in the securities of non-United States issuers; or (3) that the laws under which the foreign fund operates **did** not provide investor protections that serve the same purpose as the provisions of the Investment Company Act from which exemptions were provided.

⁷³15 U.S.C. § 80a-37(a).

⁷⁴See *supra* Section II.G.

This approach will not result in exact parity of treatment for foreign and domestic funds with respect to the 100 shareholder limitation,⁷⁵ but will eliminate most disparity without penalizing foreign funds that have never used United States jurisdictional means in any significant manner. The proposed amendment would not compel registration by a foreign fund that has never taken any steps either to offer its shares or to facilitate secondary market trading in the United States, even if it inadvertently has more than 100 shareholders who are United States residents.⁷⁶

A "shareholder of record" standard would substitute for the "beneficial owner" standard currently used in calculating and tracing United States ownership for section 7(d) purposes. The shareholder of record concept would alleviate some of the problems foreign funds have in identifying and monitoring ownership by United States residents. In defining and interpreting the concept, the Division expects to look, in part, to analogous definitions set forth in rules 12g5-1 and 12g3-2(a) under the Exchange Act.⁷⁷

Rule 12g5-1 provides that securities are deemed to be "held of record" by each person who is identified as the owner of the securities on the records of security holders maintained by or on behalf of the issuer, subject to certain qualifications. These qualifications pertain to specific circumstances under which questions could arise regarding the method of calculation. They also seek to prevent the use of artificial calculations as a means of circumventing the statute.⁷⁸ For example, the Division might look to rule 12g3-2 in interpreting who the holders of record would be in cases where foreign fund securities are held in street name for United States residents.⁷⁹ Similarly, one of the

⁷⁵United States investment companies must include both United States and foreign resident beneficial owners in their calculations for purposes of section 3(c)(1).

⁷⁶The legislative history of the Investment Company Act indicates that, despite section 7(d), Congress expected some leakage of foreign fund shares into the United States. 1940 *Senate Hearings, supra* note 20, at 199.

⁷⁷17 C.F.R. §§ 240.12g5-1, .12g3-2(a)

⁷⁸For example, subsection (b)(3) of rule 12g5-1 provides that if an issuer has reason to know that the form of holding securities of record is used primarily to circumvent the provisions of the Exchange Act, the beneficial owners of such securities shall be deemed to be the record owners of the securities.

⁷⁹Rule 12g3-2 provides in pertinent **part**:

securities held of record by persons resident in the United States shall be determined as provided in Rule 12g5-1 . . . except that securities held of record by a broker, dealer, bank or nominee for any of them for the accounts of

(continued..)

refinements provided by rule 12g5-1 that the Division might consider in the foreign investment company context is the manner in which holders of bearer securities are counted.⁸⁰ The Division expects that similar refinements of the "shareholder of record" concept in section 7(d) will assist foreign funds in calculating and tracing United States resident shareholders.

Using a shareholder of record standard, a foreign fund should be able to determine whether it is in danger of overstepping the 100 United States shareholder limit. Therefore, the 100 shareholder limitation should be ongoing, and not be restricted to a "snapshot" count taken immediately after the completion of a private offering, or one taken within a certain time period after the listing of a fund's securities on a securities exchange in the United States.

The Division believes that it would be inappropriate to place a registration obligation on a foreign fund that has never taken any steps either to offer its shares in the United States or to facilitate secondary market trading in the United States, but whose shares have inadvertently leaked into the United States.⁸¹ Therefore, under the Division's proposal, such a fund would not be required to register, even if it has more than 100 shareholders of record that are United States residents.

IV. Other Impediments to Cross-Border Sales

In addition to section 7(d) and restrictive securities laws and practices in other countries, at least two other factors significantly impede cross-border sales of investment company securities: United States tax law and state "blue sky" laws.

⁷⁹(...continued)

customers resident in the United States shall be counted as held in the United States by the number of separate accounts for which the securities are held. The issuer may rely in good faith on information as to the number of such separate accounts supplied by all owners of the class of its securities which are brokers, dealers, or banks or a nominee for any of them.

*Rule 12g5-1(a)(5), 17 C.F.R. § 240.12g5-1(a)(5).

⁸¹In defining and interpreting which steps would trigger a registration obligation, the Division expects to consider both analogous concepts set forth under other federal securities laws, *e.g.*, "directed selling efforts" under Regulation S (17 C.F.R. § 230.902(b)), and the unique investor protection concerns of the Investment Company Act.

A. United States **Tax** Law

Without amendments to United States tax laws, securing greater access for United States funds overseas most probably will not meaningfully increase sales to foreign investors. The Division recommends that the Commission support proposals to eliminate the competitive tax disadvantages for United States investment companies marketing overseas.

United States distribution requirements and withholding standards provide a strong incentive for foreign investors to invest in foreign funds rather than in United States investment companies. Under subchapter M of the Internal Revenue Code, in order to avoid taxation at the investment company level, a United States registered fund must distribute at least ninety percent of its taxable income to its shareholders each year and is subject to tax on its undistributed taxable income.⁸² Further, Internal Revenue Code section 4982 imposes an additional excise tax on a fund if it does not distribute ninety-seven percent of its ordinary income and ninety-eight percent of its capital gain net income to its shareholders.⁸³ If a fund operates within these limits, domestic shareholders receive the same tax treatment as if they owned their proportionate share of the fund's portfolio of securities directly.

Foreign investors, however, may not receive the same tax treatment under United States tax law. Foreign investors, upon receipt of fund distributions effectively mandated by subchapter M, have fifteen to thirty percent of the ordinary income and short-term capital gains distributions withheld from the distributions that they receive. Under some circumstances, if the foreign investor owned the fund's portfolio securities directly, the same income would not be subject to this withholding tax.⁸⁴ The net result is that foreign investors may incur a smaller United States tax liability by investing in securities directly rather than investing in a United States investment company.

Moreover, many foreign jurisdictions do not require an investment company to distribute income and realized capital gain in order to avoid tax at the fund level; in fact, many foreign countries do not impose any tax at the fund

⁸²26 U.S.C. § 852.

⁸³26 U.S.C. § 4982.

⁸⁴While dividends to foreign investors on United States publicly traded stocks normally are subject to withholding tax, most interest payments on short- and long-term capital gains realized by foreign investors from United States securities are generally exempt from withholding. Even though ordinary distributions by United States mutual funds are composed in large part of interest income and short-term capital gains, withholding tax still applies because mutual fund distributions are technically dividends on fund shares and are treated as such.

level. The absence of a distribution requirement permits a shareholder in a foreign fund to enjoy tax-free buildup of earnings and to avoid paying any tax until the fund shares are redeemed. Further, since several foreign countries impose little or no capital gains tax, foreign fund shareholders pay little tax upon redemption.⁸⁵

The difference in tax treatment for foreign investors in United States funds strongly suggests that any amendment to section 7(d) should be accompanied by an amendment to the Internal Revenue Code to reduce the disparity. It would make little sense to enact securities legislation that will encourage the sale of foreign investment company securities in the United States without at the same time eliminating a critical barrier to the sale of United States fund shares overseas. Of course, amending United States tax law in this area raises policy and revenue concerns, and any amendment to the Internal Revenue Code should take those concerns into account.

B. State "Blue Sky" Laws

In addition to satisfying registration requirements of section 7(d), a foreign investment company also must satisfy the applicable "blue sky" laws of each state in which it seeks to sell its securities. Because blue sky requirements vary among states, a foreign investment company selling throughout the United States would have to comply with numerous differing state blue sky requirements. This second layer of registration is arguably more burdensome for a foreign investment company than a United States investment company, since the former must also satisfy applicable regulatory requirements in its home country.

In light of the substantive federal regulation of investment companies and their investment advisers under the Investment Company Act, the Securities Act, and the Investment Advisers Act,⁸⁶ the merits of additional state substantive

⁸⁵For instance, in Germany, since capital gains retained by funds that are foreign EC registered UCITS are not taxable for private investors, investors can avoid taxation if the fund retains the capital gains. The investors might realize capital gains upon the sale of fund shares, but only if they had held the shares for fewer than six months. INT'L FIN. L. REV., *supra* note 68, at 103.

⁸⁶Investment Advisers Act of 1940, 15 U.S.C. § 80b.

review are debatable.⁸⁷ Critics argue that the costs to investors for state substantive review outweigh the benefits?

The diversity of each state's substantive and procedural blue sky requirements make compliance difficult. Critics point out that few of the various substantive requirements apply in more than a few states. For example, California is the only state that still prescribes an expense limitation. For an investment company seeking to sell in California as well as in other states, that expense limitation, in effect, establishes a nationwide standard. Critics also charge that, because of this diversity, investors who are citizens of states with rational regulatory fees and policies in effect subsidize those states with inefficient or expensive fees and policies.

The Division recommends that the Commission continue to work with state securities administrators to develop a means of coordinating and consolidating federal and state substantive regulation of investment companies. Any solution should preserve states' significant enforcement responsibility and provide that states continue to require, for notice purposes, filings of any documents filed with the Commission, consent to service of process, and requisite fees. These requirements are justifiably within the scope of states' legitimate interest in protecting their residents.

V. Conclusion

The Division recommends amendments to section 7(d) of the Investment Company Act to give the Commission greater flexibility in permitting a foreign fund to register in the United States, and to clarify, in the absence of a public offering, when section 7(d) requires a foreign fund to register. The Division also recommends that the Commission work with state securities administrators to eliminate duplicative securities regulation. These efforts may encourage foreign jurisdictions to ease some of their legal and practical restrictions on United States investment companies seeking to market abroad. Finally, the competitive disadvantages for United States funds created by the Internal Revenue Code should be addressed, although we express no view on specific terms of any amendments to the Code.

⁸⁷For example, critics charge blue sky review is less than comprehensive. They suggest that state regulators "rarely if ever examine the merits of investment company offerings." See, e.g., Davis Polk Study Comment, *supra* note 45, at 71.

**Costs include actual filing fees and the expenses of fulfilling state filing requirements. Word processing expenses, collect telephone calls from state regulators, express mail charges, and legal, professional, and other personnel fees make filing expensive. Even blue chip exemptions, intended to reduce costs for investment grade securities, may be uneconomic for investment companies, since many expire after one year, at which time an additional fee is required.

APPENDIX 4-A

**Red-Lined Version of Proposed Amendment
to the Investment Company Act of 1940**

(new language is shaded; deleted language is struck through)

Section 7 [15 U.S.C. § 80a-71.

• • •

(d) (1) No investment company, unless organized or otherwise created under the laws of the United States or of a State, and no depositor or trustee of or underwriter for such a company not so organized or created, shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to offer for sale, sell, or deliver after sale, in connection with a public offering, any security of which such company is the issuer unless it has received a Commission order pursuant to paragraph (3) of this subsection.

(2) No investment company, unless organized or otherwise created under the laws of the United States or of a State, and no depositor or trustee of or underwriter for such a company shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly:

(A) in the United States, to offer for sale, sell, or deliver after sale, any security of which such company is the issuer; or

(B) to facilitate secondary market trading in the United States, by listing the securities issued by such company on a registered securities exchange or by having its shares quoted by a registered securities information processor, or otherwise;

If such company has, or as a result of the activities in (A) or (B) can reasonably expect to have, more than 100 shareholders of record that are United States residents, unless such company has received a Commission order pursuant to paragraph (3) of this subsection.

(3) — Notwithstanding the provisions of this subsection and of section 8(a), the Commission is authorized, upon application by an operating foreign investment company not organized or otherwise created under the laws of the United States or of a State foreign country, to issue a conditional or unconditional

order permitting such company to register under this title and to make a public offering of its securities engage in the activities described in paragraphs (1) and (2) of this subsection by use of the mails and means or instrumentalities of interstate commerce, if:

(A) the Commission finds that, by reason of special circumstances or arrangements, it is both legally and practically feasible to enforce the provisions of this title against the operating foreign investment company and that the issuance of such order is otherwise consistent with the public interest and the protection of investors; and

(B) the Commission and the securities regulator of the country in which the operating foreign investment company is organized or otherwise created have signed a regulatory memorandum of understanding providing for regulatory cooperation and mutual recognition of investment company regulation by that country and the United States;

(4) The Commission may by rule or order exempt operating foreign investment companies from any provision of this title if it finds that:

(A) such exemption is necessary or appropriate in the public interest;

(B) the laws under which such company operates provide protections for investors that serve the same purposes as the protections provided by the provisions of this title from which exemption is requested or that specific conditions agreed to by the company provide such investor protections;

(C) the exemption is consistent with the protection of investors and the purposes fairly intended by the policy of this title; and

(D) the company is not operated for the purpose of evading the provisions of this title.

For purposes of this section, an operating foreign investment company is a company that is not organized or otherwise created under the laws of the United States or of a State, is primarily engaged in investing in securities of non-United States issuers, and at all times during the three-year period immediately preceding the filing of an application for registration under this title has met criteria prescribed by Commission rule or order to demonstrate that it is a bona fide operating foreign investment company.
