

**Section 7(d) of the  
Investment Company Act of 1940  
and National Treatment**

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I.  
INTRODUCTION AND SUMMARY

The purpose of this paper is to present the views of the Investment Company Institute (the "Institute")<sup>1</sup> concerning the trade implications of Section 7(d) of the Investment Company Act of 1940 (the "Investment Company Act"). In the Institute's view, Section 7(d) represents a prudential standard that ensures that U.S. investors receive the same essential investor protections whether they acquire shares in a foreign fund or a U.S.-based fund. As a prudential standard, Section 7(d) ought not be regarded as a trade issue.

Section 7(d), moreover, assumes national treatment for foreign funds: any such foreign fund that is willing to provide the investor protections required by the Investment Company Act may enjoy access to our market under Section 7(d). Permitting foreign funds to offer their shares in the United States *without* requiring that they comply with the Act would unfairly penalize U.S. funds that must comply with the Act and would put at risk the broad public confidence enjoyed by the U.S. fund industry. Moreover, while the requirements of Section 7(d) clearly impose constraints on the ability to market directly foreign investment funds in the United States, U.S. law provides for easy entry for those foreign advisers that wish to offer investment management services (including through mutual funds) here.

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<sup>1</sup> The Investment Company Institute is the national association of the American investment company industry. Its membership includes 5,825 open-end investment companies ("mutual funds"), 451 closed-end investment companies and 10 sponsors of unit investment trusts. Its mutual fund members have assets of about \$2.744 trillion, accounting for approximately 95 percent of total industry assets, and have over 38 million individual shareholders.

## II. DISCUSSION

### A. The Legislative History of the Investment Company Act

#### 1. Overview

Section 7(d) furthers the essential prudential goals of the Investment Company Act, which contains critical protections for U.S. investors. The differences found in mutual fund regulation around the world often derive from a country's historical and cultural experience. In the United States, the system came into being to address specific, well-documented abuses that had caused U.S. shareholders substantial losses. These losses happened because investment companies were organized and operated to serve the interests of fund sponsors and managers rather than investors. The resulting emphasis in the Investment Company Act on strictly regulating conflicts of interest is perhaps the most distinguishing feature of the U.S. system of mutual fund regulation.

The Investment Company Act arose out of a study conducted by the Securities and Exchange Commission (the "SEC") of abuses in the investment company industry during the 1920s and 1930s. Significant amendments to the Act, intended to strengthen the rights of investment company shareholders and the authority of the SEC to enforce the Act, were enacted in 1970. As set out in the Act's preamble, the purposes of the Act include:

- preventing insiders from managing the companies for their own benefit, rather than for the benefit of public shareholders;
- preventing investment companies from issuing securities with unfair or discriminatory provisions;
- excluding irresponsible persons from management;
- preventing the use of unsound or misleading methods of accounting and valuation and ensuring adequate independent audits; and

- ensuring that investment companies change their character only with the consent of shareholders.

The Act achieves these purposes through a number of provisions. In particular, the Act requires safeguarding of fund assets, imposes substantial restrictions on transactions with affiliates, and limits leveraging. In addition, the Act imposes a number of special corporate governance provisions on mutual funds. First, independent directors<sup>2</sup> must comprise at least 40 percent (or, in many cases, a majority) of an investment company's board. Second, the independent directors must annually approve an investment company's investment advisory contract, distribution agreement, and independent auditors. Third, shareholders must ratify the selection of the independent auditor and must approve any changes in the advisory contract, including any change in the identity of the adviser or the amount of the advisory fee. Fourth, shareholders must approve any changes in a company's fundamental investment objective or its fundamental investment policies.

The regulatory structure imposed by the Investment Company Act has encouraged the growth of a successful and highly competitive mutual fund industry in the United States. In 1940, approximately 650 investment companies, with about \$4 billion in assets, operated in the United States.<sup>3</sup> By 1995, there were approximately 6,000 investment companies, with over \$2.6 trillion in assets. This growth is in large part due to the investor confidence inspired by the regulatory scheme of the Investment Company Act. The Act

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<sup>2</sup> The Investment Company Act actually refers to persons who are not "interested persons" of the investment company. The term "interested persons" includes any employee, officer, director or 5% shareholder of the company's investment adviser or principal underwriter, any affiliate of any registered broker-dealer, and any attorney whose firm has provided legal services to the company within the past 2 years.

<sup>3</sup> Hearings Before a Subcommittee of the Committee on Banking and Currency on S. 3580, Part 1, 76th Cong., 3d Sess. 34 (1940) (statement of Robert Healy, SEC Commissioner).

does not rely on federal guarantees, but rather relies on complete and accurate disclosure, oversight by independent directors, shareholder consent, and the SEC's inspection and enforcement authority.

Although many countries have implemented special regulatory regimes for investment funds, most foreign jurisdictions do not provide protections that are comparable to those found in the Act. For example, foreign laws generally do not prohibit principal transactions with affiliates; do not provide for comparable protection of custody of portfolio securities and other fund assets; do not regulate advisory fees and sale charges; and do not require shareholder approval for critical changes in how a fund is organized or operated.

## **2. Section 7(d)**

The original version of S. 3580, the bill that ultimately became the Investment Company Act, was drafted by the SEC. Section 7(d) of that bill would have prohibited any investment company not formed under U.S. law from offering its securities in the United States:

**No investment company, unless organized under the laws of the United States or of a State, shall . . . offer for sale, sell, or deliver after sale, in connection with a public offering, any security of which [it] is the issuer.<sup>4</sup>**

David Schenker, the SEC's chief spokesman on the bill during Congressional hearings, explained that the SEC was concerned that it lacked the ability to enforce the Act against foreign corporations:

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<sup>4</sup>S. 3580, 76th Cong., 3d Sess., § 7(d) (1940).

You may ask, Why don't you let foreign corporations register? . . . .  
As a foreign corporation, we would not have any jurisdiction over  
him [sic], so he will get the benefit of being a registered company . . .  
and yet not be subject to the provisions of this bill.<sup>5</sup>

Congress was concerned that this provision represented an unfair barrier to any foreign fund that was willing to submit itself to the SEC's jurisdiction and to comply with the Act's requirements. Accordingly, in the final legislation Section 7(d) permits a foreign fund to offer its securities here so long as the SEC finds by order that "by reason of special circumstance or arrangements, it is both legally and practically feasible to effectively enforce" the provisions of the Act against the fund. Thus, Congress intended Section 7(d) to be a reasonable and flexible standard that permits a fund that was organized under the law of another jurisdiction to take steps to comply with U.S. law in order to market the fund's shares in the United States. Section 7(d) has remained unchanged since 1940.

## **B. Subsequent Experience Under Section 7(d)**

### **1. Orders Under Section 7(d)**

Section 7(d) has not represented an insurmountable obstacle to foreign funds seeking to offer securities in the United States. Issuers from Canada,<sup>6</sup> Australia,<sup>7</sup>

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<sup>5</sup> Hearings, *supra* note 3, at 196 (statement of David Schenker, Chief Counsel, SEC Investment Trust Study).

<sup>6</sup> See, e.g., *In re UBS Fund of Canada, Ltd.*, Investment Company Act Releases No. 3002 (Apr. 1, 1960) (order), 2987 (Mar. 16, 1960) (notice); *In re Templeton Growth Fund of Canada, Ltd.*, Investment Company Act Releases Nos. 2020 (Oct. 7, 1954) (order), 2015 (Sept. 20, 1954) (notice).

<sup>7</sup> See, e.g., *In re Pan Australian Fund Limited*, Investment Company Act Releases Nos. 8028 (Oct. 10, 1973) (order), 7795 (Apr. 30, 1973) (notice).

Bermuda,<sup>8</sup> the United Kingdom,<sup>9</sup> and South Africa<sup>10</sup> have obtained orders under Section 7(d). Templeton Growth Fund, Ltd. is perhaps the best known recipient of a Section 7(d) order. This Canadian fund registered under the Investment Company Act in 1954 and has been one of the best known and most successful mutual funds in U.S. history. From 1954 until 1987, when it split into two mirror funds, one Canadian and one domestic, its average annual return was approximately 15 percent.<sup>11</sup>

In an effort to standardize the application process, the SEC in 1954 adopted Rule 7d-1, which sets forth standard conditions for foreign funds seeking to obtain Section 7(d) orders.<sup>12</sup> Continuing its efforts to provide assistance to foreign funds wishing to offer shares in the United States, the SEC in 1975 issued a release setting guidelines

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<sup>8</sup> See, e.g., *In re Worldwide Fund Limited*, Investment Company Act Releases Nos. 3327 (Sept. 18, 1961) (order), 3318 (Aug. 25, 1961) (notice).

<sup>9</sup> *In re St. John d'el Rey Mining Company, Limited*, Investment Company Act Releases Nos. 7885 (June 29, 1973) (order), 7861 (June 12, 1973) (notice).

<sup>10</sup> *In re American-South African Investment Company, Limited*, Investment Company Act Releases Nos. 2756 (Aug. 13, 1958) (order), 2739 (July 3, 1958) (notice). This fund is now known as ASA Limited.

<sup>11</sup> Robert McGough & John R. Dorfman, *Templeton's Picture on Two Publications Ignites a Controversy Over Newsletters*, Wall St. Journal, Aug. 24, 1995 C1, C15. Templeton Growth Fund, Ltd. was reorganized effective December 31, 1986 into two funds. Thereafter, the Canadian company withdrew its registration under the Act. Canadian shareholders continued as shareholders of Templeton Growth Fund, Ltd., while the 58% of shareholders who were not Canadians became shareholders of Templeton Growth Fund, Inc., a Maryland corporation registered under the Investment Company Act. As of August 31, 1993, the U.S. fund had \$4 billion in assets. 2 Moody's Investors Service, Bank & Finance Manual 4712 (1994).

<sup>12</sup> Although Rule 7d-1 by its terms applies only to Canadian issuers, the SEC has stated that it may be relied upon by funds organized in other jurisdictions.

It should be noted that, because Rule 7d-1 was adopted before the widespread internationalization of the world's securities markets, some of the requirements of rule may not fully reflect market developments. However, the SEC has the ability to amend Rule 7d-1 in order to change provisions that are no longer appropriate. In addition, the Investment Company Act gives the SEC authority to exempt applicants from any of the rule's specific requirements.

generally applicable to foreign funds seeking an order under Section 7(d).<sup>13</sup> In the release, the SEC emphasized its willingness to consider exemptive applications under Section 6(c) of the Investment Company Act<sup>14</sup> for any foreign fund that could not meet all of the standards of Rule 7d-1, but that proposed alternative methods for protecting investors and for assuring that the provisions of the Investment Company Act could be adequately enforced against it.

## 2. The Unifonds Application

Perhaps the most controversial application ever filed for an order under Section 7(d) was filed by Union-Investment-Gesellschaft m.b.H. ("Union-Investment"), on behalf of Unifonds, a German mutual fund.<sup>15</sup> The application was controversial because Union-Investment, in addition to requesting an order under Section 7(d) permitting Unifonds to register, also requested exemptions under Section 6(c) of the Investment Company Act from numerous provisions of the Act which it represented were incompatible with German law or industry practice.

Among other matters, Union-Investment sought exemptions from (1) the requirement that a fund obtain a fidelity bond to protect investors against theft by fund

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<sup>13</sup> Investment Company Act Release No. 8959 (Sept. 20, 1975), 40 Fed. Reg. 45424 (1975).

<sup>14</sup> Section 6(e) in relevant part authorizes the SEC to exempt any person from any provision of the Act or any rule thereunder if it finds that the "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 [the Act]."

<sup>15</sup> See Investment Company Act Release No. 12863 (Dec. 1, 1982), 47 Fed. Reg. 57179 (1982) (notice of application).



employees;<sup>16</sup> (2) the requirement that a fund have a code of ethics to prevent fund personnel from defrauding the fund in connection with the purchase and sale of portfolio securities;<sup>17</sup> (3) the requirements that a fund have independent directors and that those independent directors annually approve the fund's investment advisory contract, its underwriting contract, and its independent auditor;<sup>18</sup> (4) the requirements that all shareholders have voting shares and that shareholders approve advisory agreements, elect fund directors, and ratify the selection of accountants;<sup>19</sup> (5) the prohibitions against certain transactions with affiliates;<sup>20</sup> and (6) the prohibition concerning purchases of securities in an underwriting in which an affiliate is a participant in the underwriting syndicate.<sup>21</sup>

In addition, Union-Investment represented that none of its corporate executives and Unifonds' distributor, custodian or accountant would enter into agreements to comply with the Act, consent to the jurisdiction of the U.S. courts, or appoint an agent for service of process in the United States. Moreover, German law would have prohibited the SEC staff from inspecting Unifond's books and records in Germany.

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<sup>16</sup> Section 17(g) and Rule 17g-1.

<sup>17</sup> Section 17(j) and Rule 17j-1.

<sup>18</sup> Sections 10(a), (b) and (g), 15(c), and 32(a).

<sup>19</sup> Section 18(f), 15(a) and (b), 16(a), and 32(a).

<sup>20</sup> Sections 10(f) and 17(a), (b), and (e)(2).

<sup>21</sup> Section 10(f).

Following the publication of a notice of Union-Investment's application, the Institute submitted a request for a hearing<sup>22</sup> on the issues raised by the application. Because of the extensive and unprecedented exemptive relief sought by Union Investment, the Institute argued that the applicants failed to meet the Section 7(d) enforceability standard and that it would be difficult for the SEC or a shareholder to enforce the provisions of the Act against Unifonds. After the SEC published a notice announcing its determination to grant the Institute's request for a hearing,<sup>23</sup> Union-Investment withdrew its application.

The failure of Union-Investment to obtain an order permitting it to register is sometimes raised as demonstrating the inflexibility of Section 7(d). In fact, to the contrary, the application demonstrates the importance of the Section 7(d) standard. Union-Investment proposed to offer shares of Unifonds in the United States without meeting significant procedural and substantive protections that Congress, in enacting the Investment Company Act, had determined were critical. For example, U.S. investors would have had no right to vote their shares, would not have had independent directors to safeguard their interests, and would have had only limited recourse to the courts to protect their interests. They also would have inadequate protections against specific abuses that the SEC had identified in its Investment Trust Study and that had led to passage of the Investment Company Act: conversion of fund assets; transactions with affiliates; and

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<sup>22</sup> Section 40 of the Investment Company Act requires that the SEC provide notice and opportunity for a hearing on any application for an order under the Act. SEC Rule 0-5 permits any interested person to request a hearing.

<sup>23</sup> Investment Company Act Release No. 13234A (May 17, 1983), 48 Fed. Reg. 23342 (1983).

"dumping" of undesirable underwritings into fund portfolios.<sup>24</sup> While the Commission has correctly stated its willingness to consider exemptive applications in connection with section 7(d), it would have been inappropriate to grant the extensive exemptive relief sought by Union Investment.

### 3. Current SEC Staff Position

The SEC and its staff have repeatedly expressed their desire to assist foreign advisers wishing to offer mutual funds in the United States. Most recently, Michael Mann, the Director of the SEC's Office of International Affairs, sent a letter to the U.K. Treasury, noting the willingness of the SEC to consider exemptive relief for foreign funds.<sup>25</sup> Mr. Mann stressed, however, that the SEC is "constrained by the prudential concerns of the Investment Company Act" and that any exemptive relief must satisfy the Act's investor protection concerns.<sup>26</sup>

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<sup>24</sup> This is not to suggest that Union-Investment in fact engaged in any practices that harmed investors. However, the protections of the Investment Company Act obviously cannot be waived simply because a particular entity has no history of misconduct.

<sup>25</sup> Letter from Michael Mann to Alan Whiting, Under Secretary, HM Treasury (June 14, 1995).

<sup>26</sup> In 1984 and 1992 respectively the Commission and its staff recommended that Congress consider amending section 7(d). While the suggested proposals would have given the SEC additional flexibility to grant orders under section 7(d), they would not have eliminated section 7(d) or changed its essential thrust. That is, the foreign fund would have to operate under laws or agree to specific conditions that provide protections to investors that serve the same purposes as the protections of the Investment Company Act. See Letter from John S.R. Shad, Chairman, United States Securities and Exchange Commission, to Thomas P. O'Neill, Jr., Speaker of the House of Representatives (January 31, 1984) (transmitting proposal to amend section 7(d)), and *Protecting Investors: A Half Century of Investment Company Regulation* (May 1992).

### **C. Section 7(d) and National Treatment**

National treatment has been defined as according "substantially the same treatment to foreign institutions in the United States as is extended to U.S. financial firms in like circumstances."<sup>27</sup> Under this definition, Section 7(d) represents a national treatment standard. It does not apply a discriminatory standard, but simply requires that a foreign fund agree to subject itself to the same investor protections as apply to a U.S. fund.

If anything, Section 7(d) applies a more flexible standard to foreign funds than applies to U.S. funds in three respects. First, Section 7(d) restricts the ability of a foreign fund to publicly market its shares in the United States, but does not otherwise restrict its activities in the United States. That is, unlike a U.S. fund, a foreign fund may engage in business in the United States, including effecting portfolio transactions in the U.S. market, without registration.<sup>28</sup> By contrast, some countries prohibit outside funds from even portfolio activities without special registration of the fund or its manager.

Second, Section 7(d) contemplates that a foreign fund may make "special arrangements" in order to accommodate differences between its home jurisdiction law or practice and U.S. laws. In addition, Section 6(c) of the Investment Company Act permits the SEC to make specific accommodations for a foreign fund, just as it can for a domestic fund, so long as the SEC is satisfied that the exemption is consistent with the protection of investors and the purposes of the Investment Company Act. In its 1975 release on

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<sup>27</sup> Department of the Treasury, *National Treatment Study* 13 (1994).

<sup>28</sup> The prohibitions applicable to U.S.-domiciled funds, set out in Section 7(a), provide that unless such a fund is registered, it cannot publicly offer its shares, purchase or redeem any security, or engage in any business in interstate commerce.

Section 7(d), the SEC noted its willingness to consider exemptive relief for foreign funds from specific provisions of the Investment Company Act.<sup>29</sup>

Third, as interpreted by the SEC staff, a foreign fund may more easily qualify as a so-called "private investment company" for the exemption from registration found in Section 3(c)(1) of the Investment Company Act than can a domestic fund. Section 3(c)(1) generally exempts from registration any investment company with fewer than 100 securityholders that is not engaged in a public offering. For a U.S. investment company, the SEC staff interprets Section 3(c)(1) as becoming inapplicable if the company has more than 100 securityholders, even if some or all are not U.S. residents. A foreign fund, however, remains eligible for the exemption so long as it has fewer than 100 U.S. persons as securityholders, even if it has thousands of foreign securityholders and even if it is engaged in a public offering outside the United States.<sup>30</sup>

#### D. Other Considerations

Section 7(d) does not serve to bar the entry of foreign money managers into the U.S. market. In this regard, it is consistent with other provisions of our domestic securities laws, under which foreign managers enjoy open access to the U.S. investment management market. A foreign adviser can register as an investment adviser under the Investment Advisers Act of 1940 (the "Advisers Act"), even without establishing a physical presence in the United States, and can manage assets for U.S. pension funds or other clients

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<sup>29</sup> See *supra*, note 13.

<sup>30</sup> *Touche, Remnant & Company*, SEC No-Action Letter (pub. avail. Aug. 27, 1984). See also *Protecting Investors*, *supra* note 26, at 213 n.75.

and organize U.S.-registered investment companies. The Advisers Act imposes no capital requirements on an adviser, and the Investment Company Act requires only \$100,000 in seed money for an investment company. The SEC staff has, moreover, in recent years taken significant steps to facilitate foreign adviser entry into the U.S. market.<sup>31</sup>

The money management industry has changed a great deal since 1940 as the popularity of mutual funds and the amount of pension assets available for management has increased substantially around the world. Money managers increasingly are more interested in providing an array of pension and mutual fund management services in a new market than they are in merely offering one or more offshore funds in that market. As a result, for business reasons, money managers are entering new markets by organizing affiliates in new markets or through acquisitions of, or joint ventures with, local firms. This, in turn, means that section 7(d) will be of decreasing relevance to foreign money managers and the steps the SEC staff has taken to facilitate foreign adviser entry into the U.S. market will be of increasing relevance.

Many foreign advisers in fact have registered as investment advisers in the United States and offer U.S. funds. Examples of advisers with substantial mutual fund assets that are either foreign entities or subsidiaries of foreign parents include INVESCO North America (\$9.4 billion in fund assets), GT Capital (\$10.2 billion), BEA Associates (\$5.2 billion), and Schroder Capital Management International (\$5.2 billion). In addition, Wells Fargo Nikko Investment Advisors, a joint venture between Wells Fargo & Co. and Nikko Securities Co. Ltd., is the largest pension fund manager and the fifth largest investment

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<sup>31</sup> See *National Treatment Study*, *supra* note 27, at 40-42.

adviser overall in the United States, with more than \$156 billion in assets under management, including \$3.6 billion in mutual fund assets.<sup>32</sup> The presence of these and other foreign-owned asset managers has helped to make ours the world's most open, dynamic and competitive market for investment management services.

By contrast, U.S. fund managers must contend with many obstacles to gain access to markets overseas. For that reason, most U.S. fund managers that market funds in Europe have established Europe-domiciled funds especially for that purpose. Some major financial centers impose restrictions that in effect bar foreign fund managers, including U.S. advisers, from operating.<sup>33</sup> Others limit the ability of U.S. managers to operate on a non-resident basis, a more restrictive position than that adopted in the United States vis-à-vis foreign managers.

### III. CONCLUSION

Section 7(d) provides for national treatment within the prudential framework of U.S. regulation. That framework has served the U.S. investing public very well, while promoting exceptional competition, diversity, and innovation within our market. The Institute strongly supports such competition and recognizes the manifold benefits that accrue therefrom. We stand ready to work with interested parties to facilitate cross-border fund offerings but believe that this must be done – as Congress clearly

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<sup>32</sup> *Special Report: Money Managers, Pensions & Investments*, May 15, 1995, at 20. Recently, the joint venture partners agreed to sell Wells Fargo Nikko to Barclays PLC, thus making the adviser wholly foreign-owned. *Wells, Nikko Selling Money Manager to Barclays PLC*. *Am. Banker*, June 22, 1995, at 1.

<sup>33</sup> See, e.g. *National Treatment Study*, *supra* note 27, at 355-56 (obstacles to fund management in Japan); 381 (obstacles in Korea); *Protecting Investors*, *supra* note 26, at 207-08 (legal barriers to offerings by foreign funds in the United Kingdom).

intended by Section 7(d) – in a manner that preserves the essential protections of the Investment Company Act and adequately protects the interests of U.S. investors.