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Comment Letter on U.S. Mutual Fund Sales in Australia, September 1999

By Facsimilie and Email

September 3, 1999

Ian Domecillo
ASIC Managed Investments
GPO Box 9827
Sydney NSW 2001

Re: ASIC 99/017 Request for Comment on PS 65

Dear Mr. Domecillo:

We are writing in response to your request for comment on the Australian Securities & Investment Commission's ASIC Policy Statement 65: Foreign Collective Investment Schemes (PS 65).[1] ASIC requested comments in two stages—first, with respect to its policy approach to US mutual funds under PS 65 and second, as part of its general review of the conditions for relief under PS 65. The Institute earlier submitted a letter relating to ASIC's policy approach to US mutual funds.[2] We appreciate the opportunity to submit additional comments on PS 65 in this letter.

PS 65 authorizes ASIC to permit the sale of foreign collective investment schemes that meet the standards set forth in the policy, and sets out the principles that guide ASIC in the exercise of its discretionary powers in this regard.[3] Conditional relief generally will be granted under PS 65 to foreign collective investment schemes that are eligible for relief and that meet certain specified conditions.[4] Funds that operate under a regulatory regime that provides a level of investor protection comparable to that found in Australia are eligible for relief. PS 65 enumerates certain classes of foreign collective investment schemes that meet this standard and thus are eligible for relief, including open-end investment companies (commonly called mutual funds in the US) and unit investment trusts registered under Section 8 of the Investment Company Act of 1940.[5]

There are several specific conditions for relief under PS 65 and Pro Forma 71 (the form upon which firms apply for relief under PS 65) that should be clarified to ensure that US mutual funds organized either as business trusts or corporations may qualify under PS 65 and that the policy permits a foreign fund to treat all its shareholders equally with respect to any suspension of redemptions. Our specific comments are explained below.

Clarifications Regarding US Business Trusts

US mutual funds most commonly are formed as either corporations or business trusts. The US concept of "business trust" differs somewhat from the Australian "investment trust," making it difficult for US funds organized as business trusts to comply with the literal provisions of PS 65 and Pro Forma 71 that use the terms "trust," "trustee" or "trust deed." Accordingly, we respectfully request certain clarifications of those provisions, as discussed below. We believe these clarifications are appropriate in that ASIC has recognized that foreign collective investment schemes (FCIS) may take different forms from traditional Australian investment trusts, and that parts of PS 65 may not apply literally to these other forms.[6]

Under US state and common law, business trusts are unincorporated associations, managed by one or more trustees, that may be organized to carry on any lawful business or activity in the US.[7] Like corporations, business trusts have status as separate legal entities. The affairs of the business trust are governed by a trust instrument, often called a "declaration of trust" or "deed of trust." The trust also may adopt bylaws, although this is not required and many business trusts choose to include the provisions commonly found in bylaws in their declaration of trust, rather than to adopt separate bylaws. The trust's declaration of trust and bylaws (if any) are analogous to a corporation's articles of incorporation (or other charter) and bylaws. For purposes of regulation under the Investment Company Act of 1940, there is no substantive difference between a fund organized as a business trust and one organized as a corporation.

It is our understanding that the typical trustee of an Australian investment trust may perform several functions on behalf of the fund, including custody of its assets, transfer agency functions, marketing, and directorial functions (i.e., fiduciary oversight).[8] This differs from the US, where these functions typically are performed by a number of different persons. In the US, the trustees of a fund organized as a business trust serve in the same capacity as directors of funds organized as corporations, and other functions are performed by other service providers. For example, a US fund's assets are held by a qualified custodian (which may include a depository), transfer agency functions are handled through a registered transfer agent, and marketing is performed by the fund's principal underwriter.

Given these differences, there are three specific provisions of PS 65 where we seek clarification as to how the word "trustee" would be interpreted in applying the provision to a US business trust:

- PS 65.25(a) requires the terms of the fund's appointment of a local agent to provide the authority and direction for the local agent to facilitate the processing of applications from Australian investors to ensure immediate transmission to the trustee of the scheme. This is a transfer agency function, and a US fund should be able to satisfy this provision by requiring its local agent to ensure transmission of information to the fund's transfer agent in the US.
- PS 65.28(e) requires that a trustee must always hold the assets of the fund. This provision should be interpreted to allow a US fund to comply with PS 65 by maintaining its assets with a qualified custodian under US law.[9] We note that Pro Forma 71 seems to support this position by requiring that "there is at all times a trustee or custodian or depository" appointed to hold title to the fund's portfolio assets.[10]
- PS 65.41(c) requires the fund's application to be accompanied by a letter of consent by the trustee of the scheme to market the scheme in Australia. With respect to a US fund, this requirement should be applied to the fund's board of directors or trustees or the board's delegate. The board (or the fund's investment adviser pursuant to delegated authority) would make the decision to market the fund in Australia.

In addition, it is our understanding that there may be some confusion as to the proper supporting documentation to file when applying for relief under PS 65 with respect to a US business trust. Pro Forma 71 requires that the fund provide ASIC with certain documents, including (i) the deed or other document or documents comprising the constitution of the fund and (ii) a certified copy of any current certificate of incorporation or registration or approval issued by the relevant agency (for US funds, the SEC) in relation to the fund.[11] As noted above, a US business trust's declaration of trust and bylaws (if any) are analogous to a corporation's charter and bylaws and serve as the fund's constitution. A certificate of trust or similar document, filed with the state in which the trust was formed, would be analogous to a corporation's certificate of incorporation. We request that US funds be permitted to provide ASIC with these documents to satisfy the Pro Forma 71 documentary standards described above.[12]

Clarification Regarding PS 65.23(d) and Pro Forma 71(11)

PS 65.23(d) requires, as a pre-condition to relief under PS 65, that the foreign fund "must not be one which is principally targeted at Australian investors or in which Australian investors represent the principal source of funds under management." Paragraph 11 of Pro Forma 71 similarly requires that "interests issued as a result of applications made in Australia represent a minority of interests in the Scheme, calculated both by value and by the number of holders of interests in the Scheme." It is our view that these requirements would not prevent a US fund from creating a class of shares for sale exclusively to Australian investors.

Rule 18f-3 under the Investment Company Act of 1940 permits US mutual funds to issue multiple classes of shares representing interests in the same portfolio. Funds generally establish multiple classes of shares as a vehicle for offering investors a choice of methods for paying distribution costs or to allow funds to access alternative distribution channels more efficiently. For example, a fund may offer A, B and C class shares where the A shares carry a front-end sales load, the B shares carry a back-end sales load and have a distribution (12b-1) fee, and the C shares are restricted to institutional investors. Multiple classes of shares of the same fund are not considered separate legal entities and their separate existence for accounting purposes is limited to the allocation of the appropriate fees and expenses.[13]

It is possible that US funds may want to create a separate class of shares for public sale in Australia.[14] This would permit the fund to tailor the distribution of that fund to a local market in which distribution expenses are charged in a slightly different way than in the US. Because distribution expenses are charged differently in Australia than in the US, we expect that some US funds may wish to establish a specific class of shares for sale to Australian investors.

Since a separate class of shares for Australian investors would not represent a separate legal entity or a separate investment company under US law, PS 65.23(d) and Pro Forma 71(11) should be applied to all classes of a fund, taken in the aggregate, rather than to any one class. A fund would still have to ensure that, taking all classes together, Australian investors would not represent a majority of the fund's assets under management or outstanding shares. We request ASIC's concurrence in this view.

Suspension of Redemptions

PS 65 and Pro Forma 71 each contain two provisions that, taken together, require that redemptions of fund shares must not be suspended or terminated for any reason without ASIC's approval.[15] For reasons explained below, we request that ASIC require US funds to seek ASIC approval only when treating Australian investors differently than US investors.

Section 22(e) of the Investment Company Act of 1940 prohibits US mutual funds from suspending the right of redemption, except under three limited circumstances. A US fund may suspend redemption rights:

(1) for any period (A) during which the New York Stock Exchange is closed other than customary week-end and holiday closings or (B) during which trading on the NYSE is restricted;

(2) for any period during which an emergency exists as a result of which (A) disposal by the fund of securities owned by it is not reasonably practicable or (B) it is not reasonably practicable for the fund fairly to determine the value of its net assets; or

(3) for such other periods as the SEC may by order permit for the protection of the fund's shareholders.[16]

In 1985, the SEC issued a release that provided guidance regarding pricing procedures when funds are closed due to emergencies such as snow storms.[17] That release states that:

The fund is expected to make every effort to price investor orders for purchase and redemption on the day the order is actually received, and to establish procedures so as to reasonably be able, following an emergency closing, to insure that investor orders can be given the price that, but for the emergency, would have been computed on the day of actual receipt.

If a fund is unable to segregate orders or redemptions, the fund may give the orders and redemptions received on the day it was closed the next price calculated after operations resume.

The 1985 release provided funds with flexibility in dealing with certain types of emergencies without seeking SEC approval. In other situations, the SEC believes that the determination that an emergency exists under section 22(e)(2), such that funds cannot fairly determine net asset value, should be made by the SEC (or the staff of its Division of Investment Management) and not by individual funds.

Since the 1985 release, however, there have been very few instances in which the SEC has made this determination. These have included emergencies affecting the markets, such as the municipal bond market break in March 1986 and the closing of the Hong Kong Stock Exchange in October 1987, and emergencies affecting individual fund operations, such as the discovery of improper accounting and a sudden change in the composition of a fund's board of directors that made any action by the fund impossible. Absent an emergency, the SEC rarely grants relief from the section 22(e) prohibition on suspending redemption rights.

US funds that are required to follow the provisions of section 22(e) and the SEC's guidance thereunder would be placed in a difficult position if they had to obtain a further approval from ASIC during an emergency. For example, if a fund realized at 9:00 a.m. that a severe storm had made it impossible to open for business and process redemption requests that day, that fund would be permitted to follow the SEC's guidance in its 1985 release and temporarily suspend or delay redemptions. At 9:00 a.m. eastern US time, however, it is 12:00 midnight in Sydney. This time difference alone would make it nearly impossible to obtain emergency relief from ASIC for another eight or nine hours, by which time the trading day in the US would be complete. This would put the fund in the very difficult position of having to decide whether to take extraordinary action to price the fund and process orders solely for Australian investors, rather than to treat all of its worldwide investors alike.

Investor protection requires that any suspension or delay of redemptions should be rare, in accordance with prescribed standards and subject to general regulatory oversight. The Institute strongly believes that any such suspension or delay also must treat all investors worldwide the same. Accordingly, instead of obtaining ASIC approval, we suggest that US funds be required to provide ASIC with notice that the fund has suspended redemptions in accordance with SEC procedures. ASIC may wish to consider the appropriate timing and form of this notice to take time-zone differences into account and to facilitate fast action in an emergency situation. For example, it may be more appropriate to require the fund to notify ASIC, rather than its local agent as required by PS 71(2)(d).

Role of the Local Agent

It is unclear whether the requirements set out in PS 65.25-26 and Pro Forma 71(2) could operate to prevent a US fund from having more than one entity distribute its shares in Australia. We are concerned with the requirement in PS 65.26 that "if persons other than the local agent . . . offer interests in the scheme to Australian investors these parties must be authorized by the local agent." This

provision would appear to permit a local agent to exercise veto power over the fund's choice of distribution channels by refusing to authorize certain selling agents, such as those that compete with the local agent or its affiliates. For these reasons, we believe that restricting a foreign fund to a single local agent for distribution will impede the ability of that fund to distribute its shares in Australia.

Moreover, this type of limitation is unnecessary. If a foreign fund meets the qualification requirements of PS 65, there is no investor protection reason to limit the fund's distribution to a single Australian agent. In the US, a registered fund is not limited to having only one sales agent and can be sold through multiple distribution outlets. In our view, the existence of several distribution channels encourages competition to the benefit of investors.

On a more general level, we request clarification that the various roles required of the local agent could be performed by different parties. For example, a fund may wish to designate its local legal counsel for a receipt of service of process, but would not want that counsel to receive and process purchase orders.[18]

Annual Prospectus Filings

PS 65.34 requires that a fund not sell securities on the basis of a prospectus that is more than 12 months old. While we agree that a fund's prospectus should be updated annually, it may be administratively difficult for US funds to assure that their prospectus is updated and filed with ASIC on the same day each year. The fund might experience, for example, delays at the printer or other administrative delays that may marginally affect the timing of the fund's filing, but would not raise investor protection concerns.[19] We therefore request a clarification that a fund would not be in violation of PS 65.34 if its annual update was not filed in Australia on the same day each year.

* * *

We appreciate the opportunity to comment on this important policy statement. If you have any questions about our comments or need additional information, please contact me at (202) 326-5826 or Robert C. Grohowski at (202) 371-5430.

Sincerely,

Mary S. Podesta
Senior Counsel

ENDNOTES

[1] IR99/017 – "ASIC to grant relief to facilitate USA 'Mutual Fund' offerings in Australia" (May 1999).

[2] See Letter to Ian Domecillo, ASIC Managed Investments, from Mary S. Podesta, Investment Company Institute (June 15, 1999).

[3] PS 65.1.

[4] PS 65.8-17 (eligibility) and 65.23-29 (pre-conditions for relief).

[5] PS 65.47(c).

[6] See PS 65.2 ("Collective investment institutions, mutual funds, investment companies, unit trusts, and prescribed interest schemes are all types of collective investment schemes. Since the structure under which FCISs operate varies considerably across jurisdictions, parts of this Policy Statement do not apply to FCISs which do not involve the offer of prescribed interests (e.g. investment companies).").

[7] See, e.g., Delaware Code T. 12, 3801 et. seq. (treatment of Delaware business trusts).

[8] PS 65.7 defines "trustee" to mean, for purposes of the policy statement, "a trustee, custodian or depositary which holds the property of the scheme."

[9] See Section 17(f) of the Investment Company Act of 1940 and the rules thereunder (relating to the custody of fund assets.)

[10] Item 6 of Pro Forma 71 (emphasis added).

[11] This requirement is embodied in the definition of "registered scheme" in section 9 of the Corporations Law, as modified by Pro Forma 71.

[12] A fund organized as a US business trust also would have to attach these documents to its registration statement with the SEC. Item 23(a) of Form N-1A, the registration form upon which US mutual funds register with the Securities and Exchange Commission,

requires the fund to attach "the Fund's current articles of incorporation, charter, declaration of trust or corresponding instruments and any related amendment" as an exhibit to its registration statement. Item 23(b) of Form N-1A requires the fund similarly to attach its "bylaws or corresponding instruments and any related amendment."

[13] Some fees and expenses may be allocated to separate classes differently, in accordance with the terms of the class and rule 18f-3 under the Investment Company Act of 1940. However, each class would share in its pro rata portion of all fund-wide expenses. For example, to the extent that a creditor had a claim against the fund, that claim would be settled from the assets of the fund and not charged to any one class in particular.

[14] Some US funds have created a separate class of shares for a particular foreign market. See, e.g., MFS Series Trust VI (class J shares available only to purchasers in Japan).

[15] See PS 65.28(f) and (g) and Pro Forma 71(7) and (9). PS 65.28(f) and Pro Forma 71(9) together require that the SEC must not relieve the fund from the requirements of the Investment Company Act of 1940 relating to the issue, buy-back or redemption of fund shares without ASIC's approval. PS 65.28(g) and Pro Forma 71(7) together prohibit the suspension or termination of buy-back or redemption rights for any reason without ASIC's approval. Pro Forma 71 makes it clear that these conditions are imposed on an ongoing basis, such that the conditional relief granted under PS 65 would be lost if at any time these conditions were not satisfied.

[16] Section 22(e) of the Investment Company Act of 1940.

[17] Release No. IC-14459 (June 6, 1985).

[18] See PS 65.25(c) and Pro Forma 71(2)(c) (service of process) and PS 65.25(a) and Pro Forma 71(2)(a) (purchase orders).

[19] We note that US funds have some flexibility in this regard. See Rule 485 under the Securities Act of 1933.
