U.S. SECURITIES LAW AS A BARRIER TO ENTRY FOR FOREIGN FUNDS

MORENIKE SAULA[*]

ABSTRACT

Very few foreign mutual funds operate in the U.S. public market, largely because of Section 7(d) of the Investment Company Act of 1940. Effectively, a foreign fund is required to restructure itself as an American investment company to comply with the 1940 Act. The need for globalization and global competition point to why it is necessary to include foreign mutual funds in the U.S. stock market. This article traces the history of attempts to overcome the hurdles posed by the 1940 Act and sheds light on why they have fallen short. It proposes several amendments to Section 7(d) that will remedy these problems. This article contends that warnings against changing this law have overlooked critical factors that would not only protect Americans but bring the United States into sync with global ways of doing business. It concludes by recommending a roadmap for Congress and regulators to adopt to lighten the burden of foreign funds under the 1940 Act whilst maintaining investor protection.

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[*] Visiting Associate Professor of Law and Business, Finance and Entrepreneurship Law Fellow, The George Washington University Law School 2018 - 2021.I would like to sincerely appreciate Carliss Chatman, Cary Martin Shelby, Del Wright Jnr, Thomas Colby and Dorothy Lund for their very helpful comments and suggestions to an earlier draft of this Article. This Article also benefitted from insightful feedback received at the George Washington University Law School Faculty Workshop Series and the Lutie/Langston Writing Workshop. Lastly. I would like to thank the editors of the U.C. Davis Bus. L. Journal for their exceptional efforts and contribution to this Article.

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I. INTRODUCTION

Foreign securities are attractive to American investors.[1] The United States Treasury report illustrates that American investors held over $13 trillion in international securities by the end of 2019.[2] This investment behavior is driven by the need to diversify investment risks away from purely domestic securities[3] and

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[1] ROBERT POZEN & THERESA HAMACHER, THE FUND INDUSTRY: HOW YOUR MONEY IS MANAGED 429-33 (2d ed. 2015) (stating that U.S. investors have continued to "increase their exposure to foreign securities . . ." over the past three decades.); *see generally* REP. OF THE STAFF OF THE U.S. SEC. & EXCH. COMM'N TO THE SENATE COMM. ON BANKING, HOUS. AND URB. AFFS, INTERNATIONALIZATION OF THE SECURITIES MARKET.

[2] DEP'T OF TREASURY, FED. RSRV. BANK OF N.Y., BD. OF GOVERNORS OF THE FED. RSRV. SYS., U.S. PORTFOLIO HOLDINGS OF FOREIGN SECURITIES, at 6 (Oct. 2020).

[3] POZEN & HAMACHER, *supra* note 1, at 6.

to obtain higher interest yield above those of domestic securities.[4] A foreign mutual fund lets people invest in foreign securities.

For many Americans, mutual funds are critical to achieving their life goals. At the end of 2019, over 103.9 million Americans used mutual funds to invest in stocks, bonds, and cash reserves.[5] Mutual funds allow investors to pool their finances with those of other investors into a collective portfolio managed and supervised by professional investment managers.[6] Institutional and individual investors alike invest in them because they provide several advantages, particularly low-cost professional investment management services, diversified investment portfolios, and "economies of scale on brokerage and other services."[7] Most individuals choose mutual funds to save for their children's college education, their retirement, and to provide an additional source of financial security for life emergencies. It's another way " 'Wall Street' can connect with 'Main Street' to improve people's lives." [8]

Although Americans find these kinds of investments important, an 80-year-old law bars foreign funds from selling shares or investment products in the U.S. Section 7(d) of the Investment Company Act of 1940 (the "1940 Act"), prohibits foreign funds from selling their shares in the U.S.[9] The U.S. Securities and

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4 *See* INV. CO. INST., INVESTMENT COMPANY FACT BOOK 64 (59th ed. 2019) (stating that American investors preferred international equity funds because the growth in the prices of U.S. stocks between 2012 – 2018 "made international equities look relatively [more] attractive . . . .") [hereinafter FACT BOOK 2019].

5 *See* INV. CO. INST., INVESTMENT COMPANY FACT BOOK (60th ed. 2020) (stating that at the end of 2019, 59.7 million U.S. households, or 46.4% of all U.S. households, owned mutual funds).

6 *See* 15 U.S.C. § 80a-3(a)(1)(A) (which defines "investment company" as any issuer that is "engaged […] in the business of investing, reinvesting, owning, holding or trading in securities…"). *See* Open-End Fund Liquidity Risk Management Programs, Investment Company Act Release No. 31835, 80 Fed. Reg. 62274, 62276 (proposed Oct. 15, 2015) (to be codified at 17 C.F.R. § 270.22e-4). *See also* Inv. Co. Inst. v. Camp, 401 U.S. 617, 625 n.11 (1971).

7 *See* THOMAS P. LEMKE, GERALD T. LINS & A. THOMAS SMITH, REGULATION OF INVESTMENT COMPANIES § 1.01 (Matthew Bender Elite Prods. rev. ed. 2014).

8 Michael B. Weiner, *A Historical Analysis of the Investment Company Act of 1940*, 10 MICH. BUS. & ENTREPRENEURIAL L. REV. 67, 67 (2020).

9 15 U.S.C. § 80a-7(d). The initial version of the bill for the 1940 Act would have permanently prohibited foreign investment companies because of the belief that it would be too difficult to enforce the 1940 Act against them. This was later changed to give the Commission the opportunity to permit foreign investment companies. *See Hearings on S. 3580 before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess., pt. 1, at 196–99, 1111–12. *See also Investment Trusts and Investment Companies: Hearing on S.3580 Before Subcomm. of the Comm. on Banking & Currency,* 76th Cong., 3d Sess. 35, at 6 (1940) (stating that

> "No investment company, unless organized under the laws of the United States or of a State, and no underwriter for a company otherwise organized, shall make use of the mails or any means of 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.")

Exchange Commission (the "Commission") is only authorized to permit foreign funds if it finds that "by reason of special circumstances or arrangements, it is both legally and practically feasible to effectively enforce the provisions" of the 1940 Act against such foreign fund.[10] The Commission must also ensure that such permission is consistent with the "interest of the public and the protection of investors."[11]

The issue with the requirement of Section 7(d) is that it does not accommodate the differences between U.S. and foreign laws. It is difficult for most foreign funds to comply with because most "[f]oreign regulatory systems … differ greatly from [the 1940 Act]."[12] Unsurprisingly, they are unable to satisfy some provisions of the 1940 Act because they either conflict with the laws and practices of their home country or because they are too burdensome.[13] The Commission also explained that Section 7(d)'s requirements "[have] proved impossible for most foreign [funds] to meet" because they require foreign mutual funds to restructure and operate as U.S. funds.[14] To that end, the Court in *Howe v. Goldcorp Invs., Ltd.* went so far as to describe Section 7(d) as imposing an "apparently absolute ban against foreign [funds'] publicly offering their shares in the U.S."[15] Because of this difficulty, only a handful of foreign funds have successfully registered under the 1940 Act.[16]

[hereinafter Investment Trusts and Investment Companies].

10 Section 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 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 to effectively 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. 15 U.S.C. § 80a-7(d).

11 *Id.*

12 *See* U.S. SEC. & EXCH. COMM'N DIV. OF INV. MGMT., PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 189 (1992) [hereinafter PROTECTING INVESTORS].

13 *Id.*

14 *Id.*

15 Howe v. Goldcorp Inv., Ltd., 946 F.2d 944, 954 (1st Cir. 1991).

16 Certain funds from Canada, Australia, the United Kingdom, and a South African fund that was later domiciled in Bermuda, have been able to obtain a Section 7(d) order. *See* INV. CO. INST.,

This Article recommends a reduction in the regulatory barriers limiting the entry of foreign funds into the U.S. to encourage more foreign fund offering in the U.S. Part IV describes this recommendation in detail. This Article first proposes an amendment to the language of Section 7(d) that allows for a more flexible approach in applying the 1940 Act to foreign funds using a Special Section 7(d) exemptive procedure; to do this, the Commission should make use of Intergovernmental Agreements to enforce U.S. securities laws on foreign funds. The entry of more foreign funds to the U.S. would increase the number of investment products available to Americans, thereby making the global market more competitive, a result that benefits not only American investors but foreign governments and businesses.[17] It will also enhance the international flow of capital to businesses, governments, and institutions around the world. [18] Finally, lower-income investors would benefit because of increased affordability.

Rule 7d-1 of the 1940 Act for Canadian funds is important to consider because it represents a key attempt by the Commission to make a special arrangement with another country. It offers a guideline for other foreign funds seeking to register under the 1940 Act.[19] After much consideration, the Commission evaluated the effects of Rule 7d-1 and agreed that the conditions are too burdensome on Canadian funds.[20] Their reasoning was that it requires them to become a "U.S. [fund] in all respects other than the location of its domicile."[21] For example, one of the conditions requires a majority of the funds' board of directors to be U.S. citizens based in the U.S.[22] Canadian funds managed and controlled by

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SECTION 7(D) OF THE INVESTMENT COMPANY ACT OF 1940 AND NATIONAL TREATMENT 5-6 (1996). Only thirteen foreign investment companies have registered under the Act since 1954 and only four of those companies were operating in the U.S. as of 1992. *See* PROTECTING INVESTORS, *supra* note 12, at 193. No foreign investment company has been granted permission to offer shares in the U.S. public market since 1973. *Id.* at 190. "[O]nly nineteen foreign funds, most from Canada, have ever received orders under section 7(d). The last such order was issued in 1973." *Id.* at 189-90, 193 n.23; *see* Pan Australian Fund., Ltd., Investment Company Act Release Nos. 7795 (Apr. 30, 1973), 38 Fed. Reg. 11141 (Notice of Application), and 8028 (Oct. 10, 1973), 2 SEC Docket 585 (Order) [hereinafter Pan Australian Fund., Ltd.].

[17] Richard M. Klapow, *Foreign Investment Company Law in the United States: The Need for Change in a Global Securities Market*, 14 BROOK. J. INT'L L. 411, 412 (1988) (noting that it will bring about notable benefits to both the "importer and exporter of financial capital.").

[18] John Shad, Chairman, Sec. & Exch. Comm'n, XI Annual Conference at International Association of Securities Commissions: International Securities Markets Benefit and Challenges (July 16, 1986), https://www.sec.gov/news/speech/1986/071686shad.pdf.

[19] *See, e.g.*, Pan Australian Fund., Ltd., *supra* note 16.

[20] Commission Policy and Guidelines for Filing of Application for Order Permitting Registration Under the Act and Sale of Shares in the United States, Investment Company Act Release No. 8959, 40 Fed. Reg. 45,424 (October 2, 1975).

[21] EDWARD F. GREENE, LESLIE N. SILVERMAN, DANIEL A. BRAVERMAN, SEBASTIAN R. SPERBER, NICOLAS GRABAR & ADAM E. FLEISHER, U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS 15-73 (12th ed. 2017).

[22] 17 C.F.R. § 270.7d-1(b)(8)(iv) (2023).

American citizens have found this easy to comply with[23]; however, funds controlled by Canadians have not.[24] The Commission similarly noted that Canadian funds may not satisfy all the conditions in Rule 7d-1 because they conflict with some Canadian laws.[25] Unsurprisingly, the adoption of Rule 7d-1 has not significantly increased the number of Canadian funds that have registered under the 1940 Act, neither has it worked well for funds from other countries.[26]

The application by a German fund, called Union-Investment Gesellschaft m.b.H. (Union-Investment), to register under Section 7(d) illustrates some of the same challenges, and demonstrates how complex the problems can be.[27] Union-Investment explained that it could not comply with some provisions of the 1940 Act and Rule 7d-1 because they conflict with Germany's regulatory system and business practices.[28] To compensate for its inability to comply with some provisions of the 1940 Act, Union-Investment proposed some alternative arrangements to the Commission to assure the protection of Americans. According to Union-Investment, such arrangements would protect Americans from the risk of fraud and market manipulation under German law.[29] Despite its proposals, Union-Investment could not secure the Commission's permission to register under the 1940 Act.

Examples similar to those seen in Canada and Germany point to how the 1940 Act, although enacted to protect American investors, has effectively barred the entry of foreign funds in the U.S. Despite repeals of laws that prevented Americans from purchasing foreign securities, Congress has done little to improve the access to foreign funds in the U.S.[30] This is primarily because of the false belief that foreign funds must comply with all the provisions of U.S. securities laws, including those that do not apply to their unique circumstances, in order to ensure

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23 Commission Policy and Guidelines for Filing of Application for Order Permitting Registration Under the Act and Sale of Shares in the United States, *supra* note 20.

24 *See* Request for Public Comments on Issues Concerning the Standards for Permitting Foreign Investment Companies to Register [15 U.S.C. § 80a-7(d)], Investment Company Act Release No. 8596, 1974 SEC Lexis 2228 (Dec. 2, 1974).

25 Offer and Sale of Securities to Canadian Tax-Deferred Retirement Savings Account Rule, 17 C.F.R. §§ 230, 240, 270, Securities Act Release No. 33-7656, Exchange Act Release No. 34-41189, Investment Company Act Release No. 23,745, 64 Fed. Reg. 14,648, 14,649 (Mar. 26, 1999).

26 GREENE ET AL., *supra* note 21, at 15-74.

27 Union-Investment-Gesellschaft m.b.H., Investment Company Act Release No. 12863, 47 Fed. Reg. 57179 (Dec. 1, 1982) [hereinafter Union-Investment].

28 *Id.* at 57180.

29 *Id.* at 57181.

30 *The Imperial SEC? – Foreign Policy and the Internationalization of the Sec. Mkts., 1934-1990: Internationalization of the Securities Markets*, SEC HIST. SOC'Y, (last visited Aug. 12, 2020), http://www.sechistorical.org/museum/galleries/imp/imp07a.php (last visited Aug. 12, 2020) [hereinafter *The Imperial SEC? – Internationalization*] (explaining that the Income Equalization Tax, and other U.S. controls that prevented Americans from purchasing foreign securities, were removed during the mid-1970s).

the protection of American investors.[31] Although this law offers a strong starting point, U.S. securities laws have failed to balance the competing interests of investor protection and globalization, particularly as it pertains to the U.S. investment company industry.

Nonetheless, some may say that there is no need to change the law. After all, American investors already access foreign securities in the U.S. public market through other means, including American Depository Receipts ("ADR")[32], U.S. funds that invest in foreign securities, and U.S. traded foreign stocks.[33] However, these have their limitations too. For instance, investing through an ADR or owning a foreign stock listed in the U.S. market may not provide sufficient risk diversification for the investor. It may also be costly for investors to seek the assistance of a financial advisor with expertise in a foreign economy. Also, investing in a U.S. fund that invests in foreign funds will prevent American investors from benefitting from the economies of scale already established by the foreign funds. It can also create an additional layer of operational and administrative costs which may reduce the investor's profit.

The argument that the law should not be changed because American funds face similar challenges abroad has become redundant as many countries have now eased their regulations to facilitate access to foreign funds in their countries.[34] Much has changed in the international community and more countries are now more open to internationalization than in the early 1990's. For example, the U.S. Treasury and Japanese Ministry of Finance signed a bilateral services agreement in 1995 that simplified the process for foreign funds to register in Japan. It was reported that "these changes resulted in a drastic expansion of assets under management by foreign [funds]."[35]

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[31] Foreign funds include foreign investment companies, offshore funds and collective investment vehicles, organized outside the United States of America. The federal securities laws that regulate the U.S. investment company industry include the Investment Company Act of 1940 ("1940 Act"), 15 U.S.C. § 80a-2 (1940); the Investment Advisers Act of 1940 ("Advisers Act"), 15 U.S.C. § 80b-1 (1940); the Securities Act of 1933 ("1933 Act"), 15 U.S.C. § 77a (1933); and the Securities and Exchange Act of 1934 ("1934 Act"), 15 U.S.C. § 78a (1934).

[32] An ADR is a negotiable receipt, denominated in shares, that allows a U.S. investor to own the shares of a foreign company through a U.S. depository bank. *See* SEC OFFICE OF INVESTOR EDUCATION AND ADVOCACY, INVESTOR BULLETIN: AMERICAN DEPOSITARY RECEIPTS (August 2012), https://www.sec.gov/investor/alerts/adr-bulletin.pdf.

[33] *See* SEC INVESTOR.GOV, INVESTOR ALERTS & BULLETINS: INTERNATIONAL INVESTING (Dec. 8, 2016), https://www.investor.gov/introduction-investing/general-resources/news-alter/alerts-bulletins/investor-bulletins/international-investing (discussing current ways Americans can invest in foreign securities).

[34] Teresa L. Turner, Note, *Proposed Amendments to Section 7(d) of the Investment Company Act of 1940: Bilateral Access and the Protection of U.S. Investors*, 27 GEO. WASH. J. INT'L L. & ECON. 209, 209-10 (1993-1994) (discussing the impediments U.S. mutual funds face under Japanese law).

[35] THE U.S. DEP'T OF THE TREASURY, NATIONAL TREATMENT STUDY, 1998: JAPAN–SECURITIES 316 http://www.treasury.gov/offices/international-

Part II of this article will examine the limitations and regulatory barriers that prevent foreign funds from registering under the 1940 Act. It will also discuss previous attempts to ease the regulatory burden on foreign funds seeking to register under the 1940 Act. Part III turns to consider why, despite this history, Congress and the Commission should try again. It discusses the importance of internationalization, as well as the benefits Americans will obtain if foreign funds operate in the U.S. public market. Part IV will propose a roadmap for amendments to Section 7(d) that will reduce the barriers to entry for foreign funds. It recommends an amendment to Section 7(d) to provide the Commission with more flexibility to permit foreign funds to operate in the U.S. It also provides steps for granting foreign funds exemptions from complying with certain provisions of the 1940 Act in the event of a conflict using what I term "purposive interpretation" of the 1940 Act. [36] It also recommends the use of an Intergovernmental Agreement (IGA) between the Commission, foreign securities regulators, and foreign funds. And Part V concludes that amending Section 7(d) to require foreign funds to comply with the purpose of the law would grant the Commission sufficient flexibility to permit foreign fund offering in the U.S stock market.

II. BARRIERS TO FOREIGN FUNDS

As discussed above, certain provisions of the 1940 Act make it difficult for foreign funds to register to sell their shares in the U.S. This section will examine why the requirements of Section 7(d) are difficult for some foreign funds to satisfy. It will highlight the Commission's proposals to amend Section 7(d) to reduce the burden for foreign funds seeking to publicly sell their shares in the U.S. It will also discuss the difficulties some foreign funds experience under the 1940 Act. Finally, this section will examine other methods foreign funds use to sell their shares in the U.S. and explain why they are not a suitable alternative.

A. Prior Attempts to Reduce the Barrier to Entry for Foreign Funds

There have been several attempts and recommendations to amend Section 7(d) with the objective of reconciling the differences between foreign regulations and practices and the 1940 Act. Even though none of the recommendations were adopted, this section will show why the Commission found it necessary to try to reduce the barriers of Section 7(d) on foreign funds.

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affairs/nts/japansec.pdf[https://web.archive.org/web/20090515015022/http://www.treasury.gov/offices/international-affairs/nts/japansec.pdf] (last visited Aug. 1, 2022.

[36] This refers to the intent or purpose of each provision of the law.

1. Foreign Portfolio Sales Corporation Act of 1973

In 1972, the Organization for Economic Cooperation and Development ("OECD") promulgated a set of "Standard Rules for the Operations of Institutions for Collective Investment in Securities" ("Standard Rules").[37] The OECD recommended that member countries review their laws regulating investment companies in light of the Standard Rules and give "substantial weight, within the framework of their legislation," to foreign funds that comply with it.[38] In response, the Commission proposed the enactment of the Foreign Portfolio Sales Corporation Act of 1973 ("1973 bill"), which sought to amend Section 7(d).[39] The proposed amendment would require the Commission to consider the "differing laws, regulations, customs and business conditions" of OECD member countries seeking to register under the 1940 Act.[40] The Commission noted that this would grant it greater flexibility in permitting foreign fund registration under the 1940 Act.[41] Unfortunately, it was not enacted, and no further action has been taken since the bill was introduced in 1973.[42]

The Standard Rules represented a significant step towards ensuring investor safety in foreign funds; however, it did not resolve the issues of conflict of laws between the U.S. and foreign countries. It only required the Commission to consider funds that complied with the Standard Rules. Similarly, it did not offer some of the protections provided for in the 1940 Act nor did it create alternative arrangements to make up for such lapses.[43] Further, the 1973 bill would not have "improved the prospects for foreign funds" because it would still contain the restrictive language of Section 7(d) that requires foreign funds to comply with all the provisions of the 1940 Act.[44]

This Article's recommendation offers a more effective solution than this proposal in that it would resolve the issue of conflict of laws using Intergovernmental Agreements. It will also remove the restrictive language contained in Section 7(d) while ensuring that foreign funds substantially comply

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[37] Org. for Econ. Coop. & Dev. [OECD], Comm. On Fin. Mkt., *Standard Rules for the Operations of Institutions for Collective Investment in Securities* (1972).

[38] Request for Public Comments on Issues Concerning the Standards for Permitting Foreign Investment Companies to Register Under the Investment Company Act of 1940, *supra* note 24, at 11.

[39] SEC, Treasury Department Memorandum entitled *Description of Foreign Portfolio Sales Corporation Proposal*, SEC HIST. SOC'Y,https://www.sechistorical.org/collection/papers/1970/1973_0403_CookSparkmanLongFPSC.pdf (Mar. 27, 1973).

[40] *Id.* Congressman Harley O. Staggers introduced this proposed bill as H.R. 8256, 93d Cong., 1st Sess. (1973).

[41] *Id.*

[42] PROTECTING INVESTORS, *supra* note 12, at 194.

[43] Request for Public Comments on Issues Concerning the Standards for Permitting Foreign Investment Companies to Register Under the Investment Company Act of 1940, *supra* note 24.

[44] *Id.*; *see also* PROTECTING INVESTORS, *supra* note 12, at 194.

with the provisions of the 1940 Act using what I term in Part IV of this article: purposive interpretation. The purposive interpretation would permit foreign funds to comply substantially with the purpose of a provision whose textual meaning may otherwise conflict with the law of the foreign fund's country of domicile or otherwise be too heavy a burden for the foreign fund to comply with. My recommendation, described in part IV, includes a more detailed approach for the Commission to grant exemptions to foreign funds on a case-by-case basis.

2. The 1975 Guidelines

Just a few years after the 1973 attempt to address this problem, the Commission created guidelines for applying the 1940 law. The 1975 guidelines did not effectively resolve the conflict of laws issues that exist between foreign and U.S. investment laws. The guidelines simply provided "minimum criteria for favorable consideration of applications that do not conform to the standard of Rule 7d-1 or which request exemptions from the provisions of the 1940 Act." [45] The Commission agreed to entertain requests for registration under Section 7(d) and requests for exemption from certain provisions of the 1940 Act under Section 6(c); however, Section 6(c) merely states that the exemption should be "necessary and appropriate" which does not adequately solve the problems facing foreign funds, namely conflict of laws and differing business practices. The Commission agreed to consider the differing laws and customs of the foreign fund's country of domicile, but failed to adopt an identifiable procedure that would have determined the success or failure of a foreign fund that follows the guidelines. In any event, the Commission states "each application will be considered in its own merits in the context of the standards of Section 7(d)", an approach that reverts the guidelines back to square one.

Despite the promulgation of the guidelines, foreign funds still struggled to register under Section 7(d).[46] Therefore, in 1983, the Commission recommended the use of mirror funds as an easier way for foreign funds to sell their shares in the U.S. because they "never resulted in a Section 7(d) order." [47] The 1975 guidelines are useful only as a screening tool for applicants under Section 7(d), falling short of solving the issue of conflict of laws. My recommendations will build off these guidelines, while further providing for appropriate solutions for the issue of conflict of laws and specific procedures for granting exemptions to foreign funds

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[45] Commission Policy and Guidelines for Filing of Application for Order Permitting Registration Under the Act and Sale of Shares in the United States, *supra* note 20.

[46] Only one foreign fund applied using the guidelines, and the application was subsequently withdrawn because it showed certain difficulties funds from civil law countries would encounter under the 1940 Act.

[47] PROTECTING INVESTORS, *supra* note 12, at 195 (noting that the guidelines "have never resulted in a Section 7(d) order.").

under the 1940 Act. Nearly two decades after the Commission issued its guidelines, it followed up with recommendations, once again hoping to promote more foreign fund registration in the U.S.

3. 1992 Recommendations

In 1992, the Commission issued a report titled "Protecting Investors: A Half Century of Investment Company Regulation" ("the Red Book").[48] The Commission made two recommendations that are worth mentioning here. Firstly, the Commission recommended that the foreign law, or the specific conditions to be agreed to by the foreign fund, should protect U.S. "investors in the same way or serve the same purpose as the provisions under the [1940 Act]." [49] To determine this, the Commission agreed to consider the different regulations, customs and business practices, but failed to provide an identifiable procedure that will determine the success of a given condition. For instance, as we shall see in the example of the German fund below, the German fund committed to some conditions it felt would protect American investors but still did not make any progress with its application.[50] My proposal, however, will first identify steps for the Commission to follow to determine whether a foreign fund can comply with the provisions of the 1940 Act. If it cannot, my proposal recommends pursuing alternate conditions that will satisfy the purposes of the relevant provision under the 1940 Act.

In 1992, the Commission also recommended the use of Bilateral Memoranda of Understanding (MOU) to properly ascertain the adequacy of foreign law to protect American investors and to foster cooperation and access to U.S. and foreign markets. The Commission recommended that it should be authorized to enter "bilateral regulatory memoranda of understanding" with foreign countries to create "a framework for regulatory cooperation and mutual recognition of investment company regulation."[51] First, MOUs are not legally binding, which means a party cannot pursue legal remedial actions in the event of a breach of one of the terms in the MOU. My proposal, however, recommends the use of an Intergovernmental Agreement (IGA) which will adequately provide cooperation and reciprocity between the Commission and its foreign counterparts. Unlike an MOU, an IGA is a legally binding document with significant consequences in the event of a breach.

The Commission's recommendations also maintained the language that "it is both legally and practically feasible to enforce the provisions of the [Act]." Unfortunately, this rigid language is the major reason foreign funds cannot register

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48 *See generally id.*
49 *See id.* at 206.
50 *See generally* Union-Investment, *supra* note 27.
51 PROTECTING INVESTORS, *supra* note 12, at 207.

under the 1940 Act. This Article, therefore, recommends replacing this language with a more suitable language to provide more successful foreign fund application under the 1940 Act.

As we have just seen, there has been some serious movement for reform of this law over the last few decades. The next section revisits an example touched on in the introduction to this article to show why reforms are still critical to pursue. The ultimately futile application of this German fund demonstrates the difficulty of overcoming the practical issues raised by the 1940 Act.

B. Applications Under Section 7(d)

1. Union-Investment Gesellschaft m.b.H.

In December 1982, Union-Investment (the German fund) applied on behalf of Unifonds, to register under Section 7(d) and to be exempted from certain provisions of the 1940 Act under Section 6(c). Union-Investment managed five mutual funds including Unifonds, a large mutual fund in Germany with over $900 million in assets.[52] Under German law, funds do not take the form of a corporation. It is an unincorporated entity without employees, that cannot sue or be sued. They operate solely based on a contract with a custodian bank and a management company.[53] The fund is supervised by a Bank Supervisory Board and managed by a management company called credit institutions which is either a joint-stock company (*Aktien-gesellschaft)* or a limited-liability company (*Gesellschaft mit beschränkter Haftung)*. The fund is considered separate from the management company even though its assets are owned and managed by them.[54] Consequently, Unifonds, was an unincorporated entity, without a legal personality, officers, or employees. It could neither sue nor be sued. Unifonds is managed by Union-Investment, a limited liability company owned by 40 shareholder banks. The shareholder banks vote on all matters concerning Union-Investment including the appointment of the Board of Supervisors.

The German fund explained that it could not comply with certain provisions of Rule 7d-1 because it conflicts with the German regulatory system and business practices.[55] It explained that its "corporate executives, distributor, custodian and accountants are not permitted to be U.S. citizens or residents under [German] law" which is a requirement under paragraph b(8)(iv) of Rule 7d-1.[56] It

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52 Union-Investment, *supra* note 27.

53 D.C. CORNER & D.C. STAFFORD, OPEN-END INVESTMENT FUNDS IN THE E.E.C. AND SWITZERLAND 11 (2019).

54 *Id.*

55 *See* Union-Investment, *supra* note 27, at 57180; 17 C.F.R. § 270.7d-1. *See also* CORNER & STAFFORD, *supra* note 53, at 3.

56 *See* Union-Investment, *supra* note 27, at 57180.

also explained that German business practices, do not permit officials or directors to have "personal liability toward fund shareholders."[57] Alternatively, the German fund explained that German law imposes a fiduciary duty on the fund's manager to operate the fund on behalf of the shareholders.[58] The German fund also stated that it is liable to shareholders under German law since it manages Unifonds. It also agreed to consent to the jurisdiction of U.S. courts and appoint agents for service of process in the U.S.[59]

The German fund, however, explained that it cannot appoint a U.S. custodian as required in Rule 7d-1 because German law requires all its assets to be held in the fund's custodian bank in Germany. German law also requires it to conduct all sales transactions in its custodian bank in Frankfurt.[60] The German fund, though, agreed to provide an irrevocable letter of credit in an initial amount of $1 million and thereafter to an amount equal to 5 per cent of the value of its U.S. outstanding shares. This would enable it to compensate for the lack of its assets in the U.S. to satisfy any judgment against it in the U.S. Finally, the German fund explained that its original books and records are kept in Germany and that it would be too expensive to ship the duplicates for inspection in the U.S.[61]

This German fund further noted that Germany maintains extensive regulatory oversight over the activities of investment funds. It explained that it's German custodian bank and the German regulatory authority, the Bundesaufsichtsamt fuer das Kreditwesen ('BAK') extensively regulates its management activities.[62] The German fund thus argued that its proposed arrangements in addition to the protection afforded by the German system is sufficient to satisfy the required standard for enforceability under Section 7(d). It explained that the "policies for facilitating the international flow of capital and practicing reciprocity with friendly nations" should allow it to register under the 1940 Act.[63] It also sought exemptive orders under Section 6(c) for certain provisions of the 1940 Act.

The Commission issued a hearing notice for the German fund's application. The Investment Company Institute (ICI) responded that permitting the German fund and granting it those exemptions may be detrimental to American investors and the U.S. mutual fund industry.[64] The problematic area for the ICI was that the

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57 *Id.*
58 *Id.*
59 *Id.*
60 *Id.*
61 *Id.* at 57181.
62 *Id.*
63 *Id.*
64 SEC Exemptive Order, Union-Investment-Gesellschaft m.b.H., Release No. IC-13234A (File Nos. 812-4707, 3-6244) (May 17, 1983).

German fund failed to meet "the standard of enforceability" under Rule 7d-1 of the 1940 Act.[65]

After waiting for several years for the Commission to review its application, the German fund withdrew its application without obtaining a decision. This illustrates the practical issues foreign funds face under the 1940 Act. The next example underscores how some provisions of the 1940 Act disparately affect foreign funds, thereby placing a heavy burden on foreign funds that seek to register under the 1940 Act.

2. ASA Gold and Precious Metals Limited

This section considers the application for an order for exemption from certain provisions of the 1940 Act under Section 7(d) by ASA Gold and Precious Metals Limited ("ASA"), a South African fund domiciled in Bermuda. Although it is thought that Section 7(d) ensures that foreign funds comply with the same provisions as U.S. regulated investment companies ("U.S. RICs"), ASA's application revealed the disparate provisions that only apply to foreign funds.

ASA applied to the Commission to permit it to maintain 80 percent of its assets in the custody of an eligible foreign custodian or eligible securities depository in certain countries.[66] ASA's request showed the disparate treatment of foreign funds and U.S. RICs under the 1940 Act. Paragraph b (8)(v) of Rule 7d-1 requires foreign funds to maintain all their assets in the U.S. except for cash it needs for administrative expenses.[67] Section 17(f) on the other hand permits U.S. RICs to maintain custody of their assets with a foreign bank without any limitation.[68] In its application for exemption, ASA explained that placing 80% of its assets outside of the U.S. will not prevent U.S. shareholders from enforcing judgment over it. It explained that U.S. federal court would have subject matter jurisdiction over it because it would involve the violation of U.S. federal securities laws. It also argued that permitting it to place its assets outside of the U.S. would not involve any greater jurisdictional concern than in the case of U.S. RICs who are permitted to maintain their assets outside of the U.S.

This shows that foreign funds should be given the same advantage as U.S. funds under the 1940 Act. ASA also stated that the condition that it must seek the Commission's prior approval before amending its custodial relationship is a burden that is also not imposed on U.S. RICs. ASA's requests illustrate this disparity in

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[65] *Id.* Specifically, the ICI contends that the applicant fails to meet what it deems the most important provisions of Rule 7d-1 of the Act, which would "undermine the ability of the Commission or a shareholder […] to enforce the […] Act against [it]."

[66] ASA Gold and Precious Metals Limited, Investment Company Act Release No. 30,539 (May 22, 2013) [hereinafter ASA Gold].

[67] 17 C.F.R. § 270.7d-1(b)(8)(v) (2023).

[68] 15 U.S.C. § 80a-17(f).

another way as well. ASA requested that the definition of "established securities exchange" be expanded to permit securities purchases and sales on the Hong Kong Securities Exchange (HKSE). Its justification for this was that the 1940 Act did not limit the securities exchanges on which U.S. RICs may transact.

The Commission granted ASA's requests stating that it is "both legally and practically feasible to effectively enforce the provisions of the 1940 Act against it and that the issuance of the order is consistent with the public interest and the protection of investors."[69] This shows that some provisions of the 1940 Act that only apply to foreign funds are unnecessarily burdensome and do not meet the notion of national treatment, which is argued by some as the reason for maintaining the strict language of Section 7(d). This application underscores why it is necessary for the commission to exercise more flexibility in permitting foreign fund registration in the U.S.

The next section will illustrate why the alternative methods foreign funds use to access U.S. markets does not in any way resolve the problems under Section 7(d).

C. The Limitations of the Alternative Methods Foreign Funds Use

Foreign funds are advised to offer their shares in the U.S. by employing several alternative methods including the use of the private offering exemption and registering as a U.S. fund. This section will explore why these alternative methods are not suitable for foreign funds.

1. Private Investment Company Exemption

A private investment company exemption permits a foreign fund to privately offer its shares to limited individuals and institutional investors.[70] While this might sound like a great way to bypass the requirements of Section 7(d), it does not serve the main purpose for which a mutual fund is formed.

Foreign issuers may offer their securities to U.S. institutional investors under Section 4(a)(2) of the 1933 Act.[71] This is known as the "private offerings" exemption.[72] They are therefore not required to register with the Commission under

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[69] ASA Gold, *supra* note 66.

[70] *See* Goodwin, Procter & Hoar, SEC No-Action Letter (Feb. 28, 1997) [hereinafter Goodwin SEC No-Action Letter] (A foreign fund must comply with Section 4(a)(2) of the Securities Act, or Regulation D or other exemption from registration under the Securities Act of 1933 ("1933 Act"), as well as Section 3(c)(1) or 3(c)(7) of the 1940 Act to make a private offering in the U.S.).

[71] 15 U.S.C. § 77(a).

[72] LARRY D. SODERQUIST & THERESA A. GABALDON, SECURITIES REGULATION 762 (9th ed. 2018).

Section 7(d) because the transactions do not involve public offerings and are unavailable to average investors.[73]

Section 3(c)(7) of the 1940 Act, permits foreign funds to privately offer its shares to qualified purchasers (individuals with a minimum of $5,000,000 worth of investments) in the U.S. without violating Section 7(d).[74] There is no restriction on how many qualified purchasers it can make a private offering to, the only requirement is that such individuals be qualified purchasers. The rationale behind this is that qualified purchasers do not need the protection of the 1940 Act since they are wealthy enough to obtain premium investment advice from a financial advisor. This is where the problem is, investment funds are designed for the public market and not for a select few, and certainly not for high-net-worth individuals but for the average investor. It therefore means that this should not even be considered as an option for foreign funds since average investors do not have $5,000,000 worth of investments.

Foreign funds are also permitted to sell their shares to a limited number of 100 non-qualified purchasers or investors under Section 3(c)(1) of the 1940 Act.[75] This is not a favorable alternative for foreign funds because it limits its access to only 100 investors compared to the vast number of investors it can reach in the U.S. public market. Further, it cannot simultaneously rely on the exemptions of "Sections 3(c)(1) and 3(c)(7) of the 1940 Act to make a private placement in the U.S. to both qualified purchasers and to less than 100 non-qualified U.S. purchasers."[76] Also, the difficulty in monitoring the secondary market to ensure that the 100 non-qualified purchasers limit is not exceeded discourages practitioners from permitting private offerings of foreign funds.[77] The Commission also admits that it is more costly and procedurally burdensome to monitor the

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[73] 15 U.S.C. § 77d-4(a)(2). *See* Reg. D ("Rules Governing the Limited Offer and Sale of Securities Without Registration under the Securities Act of 1933") contained in 17 C.F.R §§ 230.501-508 (2023) (although institutional investors can resell the stocks, such resale are only limited to institutional buyers under Rule 144A).

[74] *See generally* PROTECTING INVESTORS, *supra* note 12, at 188-89 (Qualified purchasers are individuals with a minimum of $5,000,000 worth of investments); *see also* 15 U.S.C. § 80-2(a)(51); 15 U.S.C. § 80-3(c)(7) (a qualified purchaser is any person who owns or jointly owns $5 million in qualifying investments); 15 U.S.C. § 80-2(a)(51)(ii) (companies, trusts or charitable organizations owned by family relatives with a minimum of $5 million in investments); 15 U.S.C. § 80-2(a)(51)(iii) (other types of trusts); 15 U.S.C. § 80-2(a)(51)(iv) (and any person who acts for himself or on behalf of other qualified purchasers and owns a minimum of $25 million in investments); 17 C.F.R. § 270.2a51-1(g) (2023) (Rule 2a51-1(g) provides that (with some exceptions) certain "qualified institutional buyers" (as defined by Rule 144A of the Securities Act), shall be deemed to be qualified purchasers).

[75] 15 U.S.C. § 80-3(c)(1).

[76] *See* Goodwin SEC No-Action Letter, *supra* note 70.

[77] *See* GREENE ET AL., *supra* note 21, at 15-89.

residence of U.S. purchasers.[78] As we can see, the private offering exemption is really not an option for foreign funds.

The next section will consider the viability of a master-feeder fund structure for foreign funds seeking to sell their shares in the U.S.

2. Master-Feeder Funds

A master-feeder fund structure is not a suitable alternative for foreign funds because it is not permitted in most foreign jurisdictions. Section 12(d)(1)(E) of the 1940 Act, permits a U.S. RIC (the "acquiring company" or "feeder fund") to acquire shares by another investment company (the "acquired company" or "master fund") if that is the only investment security held by such investment company.[79] Master-fund structures are arrangements through which feeder funds pool their assets and invest in a single investment company - the master fund.[80] The master and feeder fund usually have similar investment objectives; however, this may not always be the case. The onus is on the feeder-fund's investors to confirm that the master fund's objective is the same as that of the feeder fund. The use of a master-feeder fund structure will depend on whether the foreign jurisdiction permits it. Unfortunately, most jurisdictions limit the ability of a fund to invest in the shares of another investment company.[81]

Similarly, master-feeder fund structures are not suitable because the Commission requires the master fund to be organized in the U.S. This means that the foreign fund would have to organize the master fund in the U.S. Feeder funds can be organized outside the U.S., but it can only hold the securities of the master fund.[82] A feeder fund organized in the U.S. cannot hold the investment securities of a master fund organized outside the U.S. because doing so would violate Section 7(d). This is not viable for foreign funds because the multilayer structure of a master-feeder fund causes significant administrative costs and accounting expenses.[83] The U.S. master fund may also lose out on foreign investment opportunities limited to local companies.[84] Also, in the event of a default, the feeder fund may not be bound by any U.S. laws, so American investors may have no means of redress in the U.S.

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[78] PROTECTING INVESTORS, *supra* note 12, at 201.
[79] 15 U.S.C. § 80a-12(d)(1)(E).
[80] INT'L ORG. OF SEC. COMM'N, AUTHORIZATION OF COLLECTIVE INVESTMENT SCHEMES (CIS) AND RELATED SERVICES 36 (1997).
[81] *Id.*
[82] Pasadena Investment Trust, SEC No-Action Letter (Jan. 22, 1993) (If the feeder fund is domiciled in a foreign country and will not make a public or private offering to Americans, the Commission will not integrate the offerings of the two companies).
[83] ROBERT C. POZEN, THE MUTUAL FUND BUSINESS 545 (2d ed. 2002).
[84] *Id.*

Another disadvantage of a master-feeder fund structure is that most countries would tax the master and feeder funds as separate entities. This tax consequence would occur especially if the master and feeder funds are organized in separate countries.[85] Moreover, U.S. tax laws requires U.S. RICs to withhold 30% tax on foreigners.[86] This will negatively impact the foreign shareholders of the feeder fund who would otherwise not have been subject to U.S. taxation laws. Investing through a foreign fund directly is preferred because it will reassure American investors that profits will not be diverted to maintaining an entirely new entity for the sole purpose of regulatory compliance. The fees and expenses of mutual funds are a key factor for investors.[87] Therefore, funds with high expenses and fees will be unfavorable to Americans because they will bear the financial burden of the U.S. master fund and the foreign feeder fund.

The next section will examine why a mirror fund is not a preferable option for foreign funds seeking to sell their shares in the U.S.

3. Mirror or Clone Funds

In 1983, the Commission recommended that foreign funds should form a "mirror fund" to register under the 1940 Act.[88] Mirror or clone funds is the "establishment of a separate U.S. RIC […] offered in the U.S. to invest in foreign securities that 'mirrors' a foreign fund offered outside the U.S."[89] The operations of the U.S. fund must however comply with the provisions of the 1940 Act.[90] Due to the increased desire of American investors to invest in foreign securities, many fund sponsors relying on the "mirror fund" approach, have established U.S. domiciled investment companies that invest primarily in foreign securities.[91] This includes closed-end and open-end management investment companies, but this approach is not without limitations.

In theory, mirror funds seem less expensive if it's the same portfolio manager managing multiple funds to follow the same investment trend. In practice however, different local regulatory requirements may make it impossible to have a

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[85] *See* DARLA M. FERA, REGISTERED INVESTMENT COMPANY: ORGANIZATION AND STRUCTURE (2021) ("For the two-tiered structure to succeed, it is important that both tiers be able to pass their investment income and capital gains through to investors free of taxes at the fund level.").

[86] I.R.C. § 871(a)(1). However, this may be reduced if a treaty benefit applies.

[87] Inv. Co. Inst., *What U.S. Households Consider When They Select Mutual Funds, 2018*, 25 ICI RSCH. PERSP. (May 2019).

[88] Applications of Foreign Investment Companies Filed Pursuant to Section 7(d) of the Investment Company Act of 1940, Investment Company Act Release No. 13691, 49 Fed. Reg. 55 (Dec. 23, 1983).

[89] GREENE ET AL, *supra* note 21, at 15-75.

[90] *Id.*

[91] *Id.* at 15-79.

perfect "mirror" or "clone" of the foreign fund.[92] For example, mirror funds may face different regulatory limits for diversification, different costs of operation and applicable taxes, different cash balances available to invest. This can all lead to varying investment performance.[93] Also, investors examine the historical performance of a mutual fund before deciding to purchase its shares.[94] Therefore, having a U.S. fund without any historical performance of investing in a foreign country may not convince investors that it can achieve the same performance level as the foreign fund it is cloning.

4. Fund of Funds

Fund of funds is a structure whereby one investment company (a U.S. RIC) substantially invests all its assets in another investment company (the foreign mutual fund).[95] U.S. shareholders of this type of structure may be burdened by the possibility of double taxation. First from the foreign country's tax and the capital gains tax when the U.S. RICs distribute the funds. This will significantly reduce the investment yield of the investors. U.S. RICs also face several limitations in investing in foreign securities such as restrictions on investment in certain (foreign) industries.[96]

Though fund of funds may serve as an alternative means for foreign funds to offer its securities in the U.S., it is however still subject to certain 1940 Act's restrictions. Section 12(d) of the 1940 Act also provides certain restrictions on the activities of fund of funds.[97]

While this might seem like a viable option, the duplicity in roles and functions may erode the benefits of the investments. Since investors are responsible

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92 POZEN, *supra* note 83, at 546.

93 *Id.*

94 Inv. Co. Inst., *supra* note 87, at 1.

95 *See* France Growth Fund, Inc., SEC No-Action Letter (July 15, 2003) (where, a closed-end RIC sought to invest primarily in French equity securities, French Mutual funds, and other European Union Member State Funds).

96 *See* GREENE ET AL, *supra* note 21, at 15-80 (including issues such as "restrictions on investments in specific sectors or industries, exchange controls that could affect conversion of local currency into dollars, the availability of repatriation guarantees and related governmental approvals and taxation … of payments to non-residents, such as the fund, of dividend and interest income and of capital gains.").

97 15 U.S.C. § 80a-12(d) (curbing the inherent abuse in pyramid ownership when one investment company owns the shares of another investment company. This prohibition applies, if immediately after the acquisition: (i) the acquiring company owns more than 3% of the outstanding voting stock of the acquired company; (ii) the value of the securities of the acquired company exceeds 5% of the acquiring company's total asset; or (iii) the aggregate value of those securities and the securities of all other investment companies owned by the acquiring company exceeds 10% of the acquiring company's total assets. *See* 15 U.S.C. § 80-12(d)(1)(A).).

for the costs of operating the fund, American investors in a fund of fund may be responsible for the operating fee of the foreign fund and the U.S. fund.

As we have just seen, alternative measures do not resolve the issue of barrier to foreign funds in the U.S. The next section shall discuss the problems foreign issuers faced in the U.S. capital market in the early 20th century and highlight the steps Congress took to reform the laws that once barred foreign issuers in the U.S. capital market.

D. Internationalization of the U.S. Securities Market

There were lots of apprehension against foreigners during the mid-1930s.[98] Unfortunately, this was about the time the Commission was asked to conduct a study on investment companies which was later used to create the 1940 Act.[99] The initial bill of the 1940 Act completely prohibited foreign funds from making a public offering in the U.S.[100] However, this was later changed to allow the Commission to only permit foreign funds that it believes it can enforce all the provisions of the 1940 Act against.[101] During this period, the Commission believed that "anything but U.S. style securities regulation was really no regulation at all."[102] Several reports however proved that other foreign securities markets were equally regulated as U.S. markets.[103] This shows the mistrust the Commission had towards other foreign markets, hence why it insisted that foreign funds must comply with all the provisions of the 1940 Act, regardless of the regulation present in their home country.

Fortunately, the fears against foreigners subsided and the barriers preventing foreign issuers into the U.S. capital market were significantly reduced.

1. Early 20th Century International Markets

In the 1920s, securities of private foreign corporations, as well as those of foreign governments, were "widely sold" in the U.S.[104] From 1914 to 1929, Americans held about $4,130,000,000 in foreign government and foreign private

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[98] *See The Imperial SEC? – Foreign Policy and the Internationalization of the Securities Market, 1934–1990: Internationalization and Xenophobia*, SEC HIST. SOC'Y, https://www.sechistorical.org/museum/galleries/imp/imp03c.php (last visited Aug. 2, 2022) [hereinafter *The Imperial SEC? – Internationalization and Xenophobia*].

[99] The study was requested pursuant to Section 30 of the Public Utility Holding Company Act of 1935. *See also* Investment Trusts and Investment Companies, *supra* note 9.

[100] S.1775, 76th Cong., 3d Sess., at 13 (1940); H.R. 2639, 76th Cong., 3d Sess., at 13 (1940).

[101] 15 U.S.C. § 80a-7(d).

[102] *The Imperial SEC? – Internationalization and Xenophobia*, *supra* note 98.

[103] *Id.* (showing that reports from Neff and Yandell found the London Stock Exchange to be as regulated as the New York Stock Exchange).

[104] SEC, *Part V, in* REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES 2 (1937).

corporations' bonds.[105] Despite the widespread popularity of such securities, U.S. investors could not verify the information they received from foreign governments. Domestic investors also overlooked several political and economic risks, including "misstatements" in the sales literature of foreign government securities.[106] By 1934, many foreign bonds failed and approximately $1,748,898,000 loans - held by about 600,000 to 700,000 Americans - defaulted by 1934. [107] Note (It is worthy to note here that because these were individual securities not managed by a foreign mutual fund, U.S. investors would have had to rely on the advice of a personal financial advisor in purchasing these foreign securities.

Resultantly, the defaults, fraudulent conduct, and the Commission's limited jurisdictional reach developed "an overall suspicion of foreign issuers."[108] In the next section, we shall see the extent of fears concerning foreign activities in the U.S.

2. International Xenophobia

In the mid-1930s, the Commission "feared that foreigners could manipulate the market" and that it would lack jurisdiction to sue foreign violators of U.S. securities laws.[109] Some members of the Commission feared that if a world war were to occur, Europeans could withdraw all their capital from the U.S. market and therefore upend the market causing "steep price declines."[110] However, these speculations were not backed by research or empirical data.[111] Despite its lack of standing, the fear grew, and some members of the Commission began to think of ways to keep foreign capital completely out of the U.S. securities market. Some proposed high taxes and others proposed legal "barriers" to keep-foreign capital out of the U.S. In fact, the latter thought of ways to completely "isolate U.S. capital markets from [the] world."[112] These sentiments showed a great deal of xenophobia which was "increasingly at odds with President Roosevelt's growing internationalism."[113]

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105 *Id.*

106 *See The Imperial SEC? – Foreign Policy and the Internationalization of the Securities Markets, 1934-1990: Defaulted Foreign Sovereign Bonds*, SEC HIST. SOC'Y, https://www.sechistorical.org/museum/galleries/imp/imp02b.php (last visited March 11, 2023).

107 *Id.*

108 *See The Imperial SEC? – Internationalization and Xenophobia*, *supra* note 98 (U.S. banks created private committees to liaise with foreign governments; the State Department established an independent council called the Foreign Bondholders Protective Council Inc., to assist with negotiating bond settlements.).

109 *Id.*

110 *Id.*

111 *Id.*

112 *Id.*

113 *Id.*

The next section will look at the legal barriers that limited foreign activities in the U.S. capital market.

3. Post-World War II

In 1963, the U.S. economy developed a major balance of payment deficit - when a country spends more abroad than it receives.[114] The U.S. government therefore sought to "discourage [Americans] from purchasing foreign securities" and enacted controls to limit the outflow of dollars.[115] Among them was the Income Equalization Tax ("IET"), which "imposed steep taxes on Americans who acquired foreign securities."[116] The IET practically "halted the internationalization of the U.S. securities market."[117] The U.S. markets were effectively closed to Europeans seeking to raise capital; U.S. companies based abroad, began to look elsewhere to raise funds for their overseas operations.[118] And all forms of foreign securities offering in the U.S. market were blocked.[119]

As we have just seen, certain legislative measures may be necessary to fit the present situation. However, as circumstances change, it is imperative that the law evolves accordingly to fit the present situation. The 1940 Act was enacted during a very opaque period towards foreigners. However, as circumstances change, it is necessary for the law to reflect such change. As we shall see below, the apprehension about foreigners began to fade along with the laws that limited foreign activities in the U.S. As the need for internationalization grew, many of the controls that limited foreign activity in the U.S. capital market were removed.

4. Internationalization of the U.S. Securities Market

During the mid-1970's, the IET and other U.S. controls were removed, and the internationalization of the U.S. capital market and securities business increased.[120] This was one of the first steps toward the internationalization of the U.S. securities market. Yet, some Commission staff members were conflicted by internationalization.[121] In response, the then-chief of the office of International Corporate Finance, replied that the lack of internationalization would "operate to the detriment of U.S. investors" and put the U.S. market at a "competitive

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114 *See The Imperial SEC? – Internationalization*, *supra* note 30.
115 *Id.*
116 *Id.*
117 *Id.*
118 *Id.*
119 *Id.*
120 *Id.*
121 *Id.*

disadvantage."[122] He also noted that blindly applying the requirements of U.S. securities regulation to foreigners may restrict the international flow of capital.[123]

Similarly, the Commission joined the International Organization of Securities Commissions (IOSCO) along with regulators from France, the United Kingdom, Indonesia, Korea, Japan and Europe for the purpose of harmonizing "securities laws of various countries."[124] The Commission recognized the need to be "sensitive to cultural differences and national sovereignty" and therefore emphasized its willingness to be more flexible.[125]

It is important for the Commission to consider the differences between U.S. and foreign funds regulation and to likewise demonstrate a willingness to be flexible towards foreign funds.

III. BENEFITS OF PERMITTING FOREIGN FUNDS IN THE U.S.

This section will discuss the advantages of permitting foreign funds to sell their shares in the U.S. public market.

A. Diversification

Investments in foreign funds are useful to diversify portfolio risk. The concept of diversification started as early as 1774 after the 1772-1773 financial crisis where major British and Dutch banks failed due to their overexposure to the British East India Company. In response, a Dutch broker organized an investment trust called Eendragt Maakt Magt, meaning "unity creates strength." The purpose was "to provide *diversification* for small investors" with limited means and to *spread risk* by investing in international bonds or plantation loans in foreign countries.[126]

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122 Carl T. Bodolus, *The Internationalization of the Securities Markets*, 29 BUS. LAW. 107, 113 (1974).

123 *Id.* ("[T]he SEC […] need not apply blindly all the technical requirements of our Acts…. This could […] restrict the flow of capital internationally, continue the competitive disadvantages of the United States securities markets and, in the long run, perhaps operate to the detriment of United States investors.").

124 *The Imperial SEC? – Foreign Policy and the Internationalization of the Securities Market, 1934–1990: The Harmonization of Securities Laws*, SEC HIST. SOC'Y, http://www.sechistorical.org/Museum/galleries/imp/imp09b.php (last visited Aug. 12, 2020)..

125 *Id.*

126 K. Geert Rouwenhorst, *The Origins of Mutual Funds* 1, 5 (Yale Sch. of Mgmt., Yale ICF Working Paper No. 04-48, 2004) (https://repec.som.yale.edu/icfpub/publications/2450.pdf) (The countries include Austria, Denmark, Germany, Spain, Sweden, Russia and colonial plantations in Central and South America.).

In 1868, the Foreign and Colonial Investment Trust (FCIT) was established in London to provide *diversified* investment opportunities to small investors.[127] Its primary objective was to produce high interest yield above those of domestic British Consols and it successfully achieved this without unduly risking investor capital.[128]

As we can see, investing in foreign funds is useful to diversify portfolio risk by ownership of securities in other foreign stabilized economies. A well-diversified portfolio is not one that is diversified in terms of sector, companies, stocks and bonds - these qualities can only protect an investor from risks affecting a particular company, or sector.[129] A well-diversified portfolio is one that is spread across different countries or markets.[130] This will effectively protect investors from systematic risk or general market volatility that increases or reduces the price of a company's stock based on the general market performance.[131] Investing through foreign funds will help investors achieve greater diversity in foreign markets.

Americans who seek diversified foreign portfolios may invest through a U.S. RIC dedicated to investing in foreign securities. These are known as international funds or global funds. International funds invest in countries around the world except its country of domicile. Global funds invest in countries around the world including its country of domicile. But as established in Section II, forming a U.S. RIC for the purpose of investing in foreign securities is not a suitable alternative for foreign funds seeking to register under the 1940 Act.

Similarly, foreign funds have access to investment opportunities that are restricted to local buyers. This would give American investors greater access to foreign securities than they would otherwise have access to through a U.S. global or international fund.

The next section will discuss why foreign funds are useful to protect investors against investment risks in foreign countries.

B. Protects against foreign investment risks

There are international investment risks that the average investor may not be able to protect himself against, such as political risks, currency risk and

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[127] Formerly known as Foreign and Colonial Government Trust fund (FCGT). *See* D.C. CORNER & H. BURTON, INVESTMENT AND UNIT TRUSTS IN BRITAIN AND AMERICA 15 (1968) (The aim of the trust as written in its prospectus was to "provide the investor of moderate means the same advantages as the large capitalist, in diminishing the risk of investing in foreign and colonial government stocks, by spreading the investment over a number of different stocks."). *See also id.* at 16.

[128] British Consols are British Government securities that do not have a maturity date. David Chamber & Rui Esteves, *The First Global Emerging Markets Investor: Foreign & Colonial Investment Trust 1880-1913*, 522 EXPL. IN ECON. HIST. 1, 1-21 (2014).

[129] This is known as Alpha risk. *See* POZEN & HAMACHER, *supra* note 1, at 6.

[130] *Id.*

[131] This is known as Beta risk.

operational risk. Foreign funds are in a much better position to manage and mitigate the risks associated with international investments because they are better informed of the activities in the foreign market than ordinary investors. Foreign funds dedicate resources and staff to monitor investments almost on a 24-hour basis.[132] They are locally based and have local resources to monitor the companies they invest in, such as the country's political climate and other associated risks. They are also more likely to act in a timelier manner than U.S. international and global funds since they have almost immediate access to the information.[133]

The risks associated with changes in the stock index of a single country can be offset when investors can access funds from countries with "different economic performances and currency patterns."[134] It provides the safety of owning securities in other foreign stabilized economies, which can serve as a hedge in times of economic downturn in the U.S. Investing in foreign funds registered under the 1940 Act will also provide an additional layer of protection to American investors.

C. Competition

Since there are few foreign funds operating in the U.S. public market, competition between U.S. RICs and foreign funds is limited. It is important to expand market forces to not only include competition from U.S. RICs, but to also permit competition from foreign funds. Embracing the diversity and uniqueness foreign funds bring will benefit the U.S. investment company industry. Openness to such foreign competition may positively affect the quality of products and services offered to investors.

Regardless of the jurisdiction in which an investment company is domiciled, investors are only concerned with funds that can generate the highest returns at the lowest cost.[135] Shareholder demand for performance is a key driver of competition in the investment company industry.[136] The cost of investing is also a major driver of competition among investment funds. Even smaller funds with higher operating costs are forced to lower their fees to match the fees offered by larger funds.[137]

Permitting foreign funds in the U.S. public market can introduce new investment products and innovation that can attract more investors to invest through mutual funds. At the end of 2019, 89 per cent of the $21.3 trillion mutual

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132 *See* POZEN & HAMACHER, *supra* note 1, at 537.
133 *Id.*
134 Patrick Merloe, *Internationalization of Securities Markets: A Critical Survey of U.S. and EEC Disclosure Requirements,* 8 U. PA. J. INT'L L. 249, 252 (1986).
135 Brian Reid, *Competition in the Mutual Fund Business*, INV. CO. INST. RSCH. COMMENT. 4 (2006), https://ici.org/pdf/rc_competition.pdf.
136 *Id.*
137 *Id.* at 6.

fund assets were obtained through retirement accounts.[138] Permitting foreign mutual funds may increase the demand for direct investment in mutual fund products, decreasing dependency on retirement accounts. Some foreign funds permit investors to invest as little as $100 ("pocket change") with no redemption limits; this attracts individuals from all walks of life to directly invest in a mutual fund.[139] Permitting more foreign funds in the U.S. public market will introduce new innovative services that may cause more individuals to directly invest in mutual funds rather than through retirement accounts.

D. Fairness

It is unfair to leave the difficulty foreign funds face under the 1940 Act unresolved because requiring foreign funds to register as a U.S. RIC is not an adequate solution to the problems foreign funds face under the 1940 Act. It is also important to resolve the issue because foreign countries have removed regulatory barriers that once prevented U.S. funds from registering to sell securities in their country. For example, China has recently reorganized its laws to permit more foreign fund registration. Now, foreign funds are no longer required to partner with a local Chinese company to sell their shares in China.[140] Foreign funds can now fully own and operate their mutual fund business in China.[141] Many U.S. firms have already begun to register their wholly owned mutual fund businesses in China. This is a significant move in the international investment company industry and an example that we should emulate.

As we can see, opening the door for foreign funds to operate in the U.S. will further encourage other countries to similarly permit more U.S. fund operation in their country. The next section will discuss my recommendations for how we can resolve the issues foreign funds face under the 1940 Act.

IV. RECOMMENDATIONS TO PERMIT FOREIGN FUNDS IN THE U.S. PUBLIC MARKET

This section recommends that Section 7(d) should be amended to give the Commission more flexibility to permit foreign funds to operate in the U.S. It also provides steps for granting foreign funds exemptions from certain provisions of the 1940 Act. Further, it recommends the use of an Intergovernmental Agreement (IGA) between the Commission and foreign regulators and foreign funds.

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[138] *See* FACT BOOK 2019, *supra* note 4, at 140.

[139] Ant Financials' Yu'E bao, which means "leftover treasure."

[140] Thomas Hale, *BlackRock wins Chinese approval for mutual fund business*, FIN. TIMES (June 10, 2021), https://www.ft.com/content/5bb13be2-68da-4e53-8d32-5340b67ef82f.

[141] *Id.*

A. Amend Section 7(d)

Section 7(d) states that "it must be legally and practically feasible to enforce the provisions" of the 1940 Act against foreign funds; this language should be removed because it serves as a de facto ban on foreign funds. As this article has demonstrated, it is difficult for the provisions of the 1940 Act to be enforceable against foreign funds "legally and practically" because of the differences in their regulation and practices. Section 7(d) should therefore be amended to authorize the Commission to permit foreign funds, "*if it finds that such order is consistent with the intent and purpose of the Act and the best interest of the public and the protection of investors.*" This will offer the Commission more flexibility in granting a Section 7(d) order. Amending Section 7(d) in this way will ensure that foreign funds are able to comply with the purpose of the 1940 Act where, due to conflict or other impracticality, it cannot comply with the textual requirement of the law.

B. Procedures for Granting Section 7(d) Exemption Orders

Although Section 6(c) permits the Commission to grant exemptions, this Article recommends that Section 7(d) should contain a provision for granting foreign funds exemption orders for the purpose of registering under the 1940 Act. This is necessary to distinguish the basis of the exemption as one required for foreign fund registration under the 1940 Act. While Section 6(c) can be relied on for other types of exemption not relating to foreign fund registration. The provision for exemption under Section 7(d) should permit the Commission to determine (1) if the foreign fund can comply with the textual interpretation of the law and (2) if the foreign fund can comply with the *purposive* interpretation of the law. If it can comply with the textual interpretation of the law, then there would be no need for an exemptive order. But if it cannot comply with the textual interpretation of the law, then the Commission should determine if the foreign fund can comply with the *purposive* interpretation of the law.

As Congress enacts the law, it is the Commission's duty to give meaning to Congressional intent by turning laws into action.[142] The textual interpretation refers to the word-for-word, interpretation of every provision of the 1940 Act. As it stands, the current provision of Section 7(d) that states the provisions of the 1940 Act be "legally and practically enforceable against foreign funds" requires a textual interpretation of the law. There are circumstances where the textual interpretation may be feasible for foreign funds such as the requirement to submit relevant financial statements. However, in some situations, enforcing the textual provisions of the 1940 Act may be difficult for foreign funds to comply with because it

[142] *See* ROBERT A. KATZMANN, JUDGING STATUTES (2014), for more on the relationship between Congress and Agencies in interpreting and implementing statutes.

conflicts with their own laws and customs or because compliance may produce an unjust result.[143] In such situations, it is important for the Commission to look beyond the text of the statute to fully bring to life Congress's intention without prejudice to foreign funds. This approach requires the Commission to apply the purposive interpretation of the relevant provision.

The next section will provide a roadmap for granting the proposed Section 7(d) exemptive orders using the application of the German fund.[144] It will specifically explain how the Commission may grant or refuse to grant an exemptive order, depending on whether it finds that the foreign fund can comply with the purposive interpretation of a provision under the 1940 Act.

1. Applying the Proposed Section 7(d) Exemptive Order to Paragraph (b)(1) of Rule 7d-1

Paragraph (b)(1) of Rule 7d-1 of the 1940 Act requires present and future officers, directors, investment advisers, principal underwriters and custodians of foreign funds, to comply with all relevant provisions of the 1940 Act.[145] It also requires the foreign fund to designate the shareholders as beneficiaries to grant them the right to file a legal action in U.S. courts in the event of a breach of agreement. Paragraph (b)(6) of Rule 7d-1 of the 1940 Act gives shareholders the

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[143] For example, where German law requires Union-Investment to maintain its assets with a German bank in Germany and U.S. law requires it to maintain its assets in the United States with a U.S. custodian bank.

[144] The proposed procedure for granting a Section 7(d) exemptive order requires the Commission to determine if: (1) the foreign fund can comply with the 'textual interpretation' (meaning word for word interpretation) of the relevant provision of the 1940 Act. If it cannot, then the Commission will determine if: (2) the foreign fund can comply with the intent and purpose of the particular provision ('purposive interpretation').

[145] (1) Applicant will cause each present and future officer, director, investment adviser, principal underwriter and custodian of the applicant to enter into an agreement, to be filed by applicant with the Commission upon the filing of its registration statement or upon the assumption of such office by such person which will provide, among other things, that each such person agrees (i) to comply with the applicant's Letters Patent (Charter) and By Laws, the act and the rules thereunder, and the undertakings and agreements contained in said application insofar as applicable to such person; (ii) to do nothing inconsistent with the applicant's undertakings and agreements required by this section; (iii) that the undertakings enumerated as paragraphs (b)(1)(i) and (ii) of this section constitute representations and inducements to the Commission to issue its order in the premises and continue the same in effect, as the case may be; (iv) that each such agreement constitutes a contract between such person and the applicant and its shareholders with the intent that applicant's shareholders shall be beneficiaries of and shall have the status of parties to such agreement so as to enable them to maintain actions at law or in equity within the United States and Canada for any violation thereof. In addition, the agreement of each officer and director will contain provisions similar to those contained in paragraph (b)(6) of this section. 17 C.F.R. § 270.7d-1(b)(1) (2023). Paragraph (b)(2) provides that any violation of the agreement entered into pursuant to paragraph (b)(1) can lead to a revocation of any order granted under Rule 7d-1. 17 C.F.R. § 270.7d-1(b)(2) (2023)

right to sue any officer of the foreign fund.[146] Therefore the foreign fund, its officers, and directors must submit to the jurisdiction of U.S. courts and agree that any U.S. court's judgment will be enforceable in a court in their respective jurisdiction.

The German fund requested an exemption from these provisions because, under German law, its officers and directors are not personally liable to shareholders.[147] German law imposes personal liability on fund managers because they operate the fund on behalf of the shareholders. Therefore, requiring the German fund's officers and directors to become personally liable to U.S. shareholders would be a burden they do not bear under German law. The German fund, however, noted that its fund manager is liable to shareholders under German law. Union-Investment, which serves as the German fund's management company, is also liable to shareholders under German law. It, therefore, agreed to comply with the provisions of the 1940 Act, consent to the jurisdiction of the U.S. courts, and hold themselves liable to their American shareholders. That the officers of the German fund would not be liable to U.S. shareholders means that none of its officers will owe a fiduciary duty to the shareholders, mainly a "duty of care" and "duty of loyalty." [148]

Under this scenario, the German fund cannot comply with the textual interpretation of the provisions because its officers are not personally liable under German law. Logically, then, the first item the Commission should determine is the purpose of Paragraph (b)(1) and (b)(6). It can be implied here that the purpose is to ensure that the Commission and American shareholders have the right to pursue legal action in the U.S. against officers of a foreign fund in the event of a breach. Section 36 of the 1940 Act permits the Commission to bring an action against officers or directors of a RIC in the case of a breach of fiduciary duty involving personal misconduct.[149] The Courts have also interpreted this to include private actions by shareholders, since they are the ones the 1940 Act seeks to protect.[150]

The next thing the Commission should determine is if Union-Investment's commitment to consent to the jurisdiction of U.S. courts and to be liable to U.S. shareholders is sufficient to satisfy the purposive interpretation of Paragraphs (b)(1) and (b)(6). Usually, the officers and directors of a company bear the fiduciary duty to protect the company's shareholders. It is, therefore, unlikely that the Commission will deem Union-Investment a perfect substitute for its officers and

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146 17 C.F.R. § 270.7d–1(b)(6) (2023).
147 Union-Investment, *supra* note 27, at 57180.
148 This is an established principle that permits company's shareholders to bring a derivative action on behalf of the corporation against directors for breaching their fiduciary duty. Fed. R. Civ. P. 23.1.
149 15 U.S.C. § 80a-35.
150 McLachlan v. Simon, 31 F. Supp. 2d 731, 825 (N.D. Cal. 1998) (citing Bancroft Convertible Fund v. Zico Inv. Holdings, Inc., 825 F.2d 731, 736 (3d Cir. 1987)) (quotations omitted).

directors. The Commission may alternatively require Union-Investment's fund manager to submit to U.S. jurisdiction and agree to comply with all the provisions of the 1940 Act since the fund manager is personally liable to shareholders under German law. While this requirement may not completely satisfy the purpose of the provisions, it ensures that the fund manager, an officer of the German fund, is personally liable to U.S. investors under U.S. law.[151]

The next section will explain how the Commission may apply the purposive interpretation to the German fund's application for exemption from Paragraphs (b)(3), (b)(5) and (b)(7) of Rule 7d-1.

2. Applying the Proposed Section 7(d) Exemptive Order to Paragraph (b)(3) of Rule 7d-1

This section will apply the purposive interpretation to paragraphs (b)(3), (5) and (7) and determine if the use of a letter of credit is sufficient to achieve the purpose of these provisions. It will conclude, by determining that a letter of credit is indeed sufficient to fulfill the purpose of these Paragraphs.

Paragraphs (b)(3), (5) and (7) require the assets of a foreign fund to be based in the U.S.[152]

It requires that the foreign fund consents to U.S. court's jurisdiction to distribute its assets in the event of a breach of agreement. It also requires the foreign funds' primary custodian to be based in the U.S. and assigned as the agent for service of process in the U.S. The German fund explained that its officers, directors, and custodians are not permitted to be U.S. citizens or residents under German law. Therefore, there is no way its custodian can be based in the U.S. It also explained that German law requires all its assets to be kept with a custodian in Germany, and so, it is not permitted to place any of its assets in the U.S.

As suggested, the issue here concerns a conflict of laws between the U.S and Germany. As a result, the German fund cannot comply with the textual provisions of paragraphs (b)(3), (5) and (7) of Rule 7d-1. To make up for this, the

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[151] The Commission may also recommend to its German counterpart, BAK, to require officers and directors of German investment companies to be personally liable to the shareholders, if Germany executes the proposed Model 1 IGA with the Commission.

[152] Paragraph (b)(3) states that the Commission can revoke the order giving permission to make a public offering and may distribute the applicant's assets to satisfy its investors in the event of a breach of the order or Act. 17 C.F.R. § 270.7d-1(b)(3) (2023).

Paragraph (b)(5) states that any shareholder of the applicant shall have the right to bring a claim against the applicant in a U.S. court and seek for the following remedies: (i) that the applicant's permission to publicly offer shares be revoked; and (ii) that *applicant's assets be distributed among its shareholders and creditors.* This is after the applicant has received notice of such claim and has had the opportunity to be heard. 17 C.F.R. § 270.7d-1(b)(5) (2023).

Paragraph (b)(7) requires the applicant to *irrevocably assign its custodian as an agent for service or process in the U.S.* 17 C.F.R. § 270.7d-1(b)(7) (2023).

German fund decided to make an irrevocable letter of credit for $1 million and then a subsequent payment of five percent of the value of its outstanding shares in the U.S.[153] The amount on the letter of credit will be adjusted every month to meet the five percent value of the fund's outstanding shares in the U.S. The letter of credit will be payable to any person who has not received payment to satisfy a court judgment against the German fund. The purpose of the letter of credit is to guarantee to the beneficiary that the stated payment will be made if the applicant defaults on its obligations to the beneficiary. This is known as a standby letter of credit.

The next item the Commission must determine is the purpose behind paragraphs (b)(3), (5) and (7) and if the use of a letter of credit will satisfy this purpose. It can be implied here that the purpose of the provisions is to ensure that the Commission or shareholders are able to utilize the assets of the German funds to satisfy any judgment against the German fund in U.S. courts. Letters of credit are governed by a principle of independence that ensures that all the contracts in a letter of credit transaction are separate and independent from each other.[154] Here, the document that would be required from the Commission or an American shareholder or investor is a judgment from a U.S. court against the German fund for the violation of U.S securities laws, and proof that the German fund has refused to satisfy the judgment after demand. The bank will then honor the letter of credit, whether the German fund is able to repay the bank or not.

Based on this, it seems likely that a letter of credit will be sufficient to satisfy any U.S. court judgment against the German fund. The only issue that may arise with this is if the German fund refuses to satisfy the court judgment and the amount awarded by the court is more than the amount stated on the letter of credit. In such a case, the Commission can ensure that the German fund issues a letter of credit that will sufficiently cover the interests of U.S. investors. Alternatively, using the next recommendation below on intergovernmental agreements ("IGA") (in Section IV- D), the Commission can ask its foreign counterpart, BAK, to

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[153] A letter of credit is an "irrevocable undertaking for the payment of money, issued by a bank at the request of its customer and in favor of a third-party beneficiary." PRACTICAL LAW FINANCE, LETTERS OF CREDIT IN FINANCING TRANSACTIONS TOOLKIT (2020), Practical Law Toolkit 7-561-9286. Letter of credits are governed under Article 5 of the Uniform Commercial Code (UCC).

[154] PRACTICAL LAW BANKRUPTCY & RESTRUCTURING, TREATMENT OF LETTERS OF CREDIT IN BANKRUPTCY (2020), Practical Law Practice Note w-001-5100. There are three contracts in every letter of credit transaction. Here, the first contract will be between the applicant -the German fund and the beneficiaries -American shareholders and the Commission. The second is the contract between the German fund and the issuer (bank) reflecting the German fund's obligation to repay the issuer when the beneficiary draws on the letter of credit. The third contract is between the issuer (bank) and the beneficiary (American shareholders and the Commission). This contract is independent from the first two contracts. Here, the issuer is required to honor the letter of credit once the beneficiary submits certain documents to the issuer. After examining that the documents comply with the terms of the letter of credit, the bank will make the specified payment to the beneficiary.

enforce the judgment of the U.S. court over the German fund since BAK has jurisdiction over its assets.[155]

3. Applying the Proposed Section 7(d) Exemptive Order to Section 10(a)

This section will apply the purposive interpretation to Section 10(a) of the 1940 Act and conclude by recommending that the Commission require the appointment of additional independent directors to the board of foreign funds that do not meet the minimum threshold under the 1940 Act.

Section 10 (a) of the 1940 Act states that no more than 60% of interested persons should be employed as officers or directors of a RIC.[156] This requirement conflicts with the practice of the German investment company industry as German law does not embody the concept of "independent directors."[157] The role of independent directors under the 1940 Act is to serve as "watchdogs" and to provide "an independent check on management."[158] The requirement for independent officers and directors is essential to safeguard shareholders' interest because it minimizes the risk for conflict of interest. It also assures investors that their money is not in the wrong hands. It is a minimally invasive way for the government to provide an added layer of protection that is inexpensive and guaranteed.

Whilst most foreign jurisdictions do not embody the concept of independent directors, the Commission can ask the foreign fund to appoint additional independent officers with significant voting rights to its board. This will ensure that the voting power of independent officers outweighs that of the interested directors. This arrangement may satisfy the purpose of Section 10(a), which is to ensure the protection of investors from interested persons. Alternatively, the Commission may also consider arrangements that will give disinterested officers the power to override the decisions and activities of interested directors. Further, using the next recommendation below, the Commission can negotiate special arrangements to provide additional checks on the activities of the interested directors under an IGA.

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[155] This will apply if Germany is a "partner country." (See Section IV (C) below on Intergovernmental Agreements).

[156] 15 U.S.C. § 80a-10(a). An interested person is someone who is affiliated to the fund (15 U.S.C. § 80a-2(a)(19)).

[157] Union-Investment, *supra* note 27, at 57182.

[158] H.R. REP. No. 91-1382, at 13 (1970). The principle of independent directors is a proactive way to safeguard the interest of investors. It is not a reactive way of protecting shareholders like shareholders litigation. Similarly, litigation can be expensive and time-consuming. Independent directors offer less expensive protection for investors.

C. Intergovernmental Agreement (IGA)

To foster cooperation and reciprocity the Commission should execute intergovernmental agreements with their regulatory counterpart in foreign countries. As noted above, an intergovernmental agreement (IGA) is a legally enforceable contract between two or more governmental agencies. It holds the same status as executive agreements under U.S. law, and, therefore, does not require the advice and consent of the Senate.[159] It is worth noting here that Congress may, however, need to authorize the Commission to enter into such agreements with foreign countries.

There is a precedent for this kind of use of IGAs. The U.S. Treasury and the Internal Revenue Service (IRS) utilize them to ensure that foreign financial institutions (FFIs) comply with the provisions of the Foreign Account Tax Compliance Act (FATCA).[160] The U.S. Treasury executes Model 1 IGA's with foreign countries to foster cooperation and regulatory compliance with its regulatory counterpart in the foreign country. In fact, countries that execute a Model 1 IGA with the U.S. Treasury are called "FATCA partner countries." Such countries agree to collect the necessary foreign account information on U.S. persons from the FFIs within their jurisdiction, which they then pass onto the IRS.

FFIs organized in FATCA partner countries are recognized as "registered deemed-compliant FFIs."[161] These FFIs do not need to sign separate IGAs with the U.S. Treasury. In the event of a significant non-compliance, the U.S. Treasury will notify the relevant foreign authority in the FATCA partner country. After issuing the notice of non-compliance, the FATCA partner country or the IRS will take enforcement actions against such FFI. Countries may sign a reciprocal or non-reciprocal Model 1 IGA depending on whether there is an existing treaty between the U.S. and the foreign country.

Furthermore, FFIs organized in countries that do not sign the Model 1 IGA may enter into a Model 2 IGA with the IRS. The Model 2 IGA requires FFIs to report the relevant information on U.S. persons directly to the IRS. In the event of a significant noncompliance, the IRS will pursue enforcement actions against such FFI. Notably, Model 2 IGAs are non-reciprocal agreements.

The Commission should similarly execute IGAs with foreign countries and foreign funds using this example from the U.S. Treasury. This way, the Commission can execute a Model 1 IGA with foreign countries for cooperation between the Commission and its foreign regulatory counterpart.[162] Countries that

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[159] They may, however, be treated differently in foreign countries (for example, as a treaty).

[160] U.S. DEPT. OF TREASURY, FOREIGN ACCOUNT TAX COMPLIANCE ACT, http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx.

[161] 26 C.F.R. § 1.1471-5(f)(1) (2023).

[162] For example, the Commission can execute an IGA with the Financial Conduct Authority in the U.K.

sign the Model 1 IGA can be referred to as "partner countries" and the foreign funds organized in the partner countries can be referred to as "recognized funds." Such funds will not need to sign separate IGAs with the Commission. The Commission can also sign a reciprocal IGA with partner countries to ensure that U.S. funds receive similar treatment in the foreign country. The reciprocal IGA can also safeguard the interest of U.S. funds to ensure they have equal access to market benefits in the foreign country, a solution would resolve the concern that U.S. funds may not receive reciprocal treatment in foreign countries. The Commission can also negotiate with partner countries to enact favorable laws and make necessary adjustments where their regulations conflict with the provisions of the 1940 Act. This form of cooperation will advance the international regulation of the investment company industry, as Countries will begin to adopt regulatory practices that will promote market internationalization.

The agreement will particularly be relevant to the enforcement of U.S. securities laws against 'recognized funds.' For example, in the event of a pending litigation against a recognized fund in the U.S., the Commission may ask the regulator in the partner country to seize the assets of the recognized fund pending the determination of the suit. This kind of cooperation is critical to safeguard the interests of U.S. investors.

Foreign funds not organized in a Model 1 jurisdiction can sign a Model 2 IGA with the Commission. This will grant the Commission significant enforcement powers against such foreign funds in case of a breach. Foreign funds that sign a Model 2 IGA can be called "participating foreign funds." Like with FATCA, the Model 2 IGAs may be nonreciprocal.

V. CONCLUSION

Section 7(d) significantly prevents Americans from accessing foreign funds in the U.S. public market, denying millions of Americans access to foreign mutual fund offerings. The regulations in place significantly hinder foreign funds from offering its shares in the U.S. public market. The 1940 Act was designed to curb abusive activities of bad actors that existed before 1940.

Amending Section 7(d) to replace the language "legally and practically feasible to enforce the provisions of [the 1940 Act]" against foreign funds with "the order be consistent with the intent and purpose of the Act and with investor protection and the best interest of the public" will permit the Commission to look significantly beyond the textual provisions of the law and focus on the purposive interpretation when granting a Section 7(d) order. Amending the provision of Section 7(d) will give the Commission more flexibility to enter special arrangements with foreign funds to enable it to register under the 1940 Act.

The proposed Section 7(d) exemptive order will authorize the Commission to exempt foreign funds from complying with the textual interpretation of a

provision where it will conflict with foreign laws or otherwise make it too difficult for foreign funds to satisfy due to differences in laws and customs. The purposive interpretation will permit the Commission to enter into special arrangements with foreign funds that will comply with the legal provision's purpose. This interpretation will significantly promote internationalization because it will permit more foreign funds to be eligible to register under the 1940 Act. Finally, issues pertaining to investor protection and lack of jurisdiction over foreign funds' assets can be resolved using IGAs with foreign governmental agencies. Reciprocal IGAs can also ensure that U.S. RICs receive similar treatment in the foreign country. This form of cooperation will enhance the international regulation of investment companies.