M E M O R A N D U M

October 14, 1971

To: The Commission

From: The Division of Corporate Regulation

Re: Institutional Investors Study
Implementation Memorandum No. 7 - Offshore Funds

As discussed with the Commission, we have established a "task force" to consider the foreign portfolio sales load proposal and related matters which are discussed in Chapter VII of the Institutional Investor Study report. In addition to Messrs. Freedman and Mostoff for the Commission, the principal members of the task force are senior staff officials of the Treasury Department. Representatives of the State Department and Federal Reserve Board also participate in meetings.

After several meetings, the task force has produced a draft proposal to implement the foreign portfolio sales corporation recommendation. A copy is attached. Essentially, the proposal envisions a regulated investment company with tax treatment under the Internal Revenue Code comparable to that now afforded to offshore funds.*

The next step, so far as the task force is concerned, is to expose the proposal for informal comment to a number of persons - both industry representatives and lawyers who have had considerable offshore fund experience. Before doing this, however, we thought it appropriate to submit the attached draft proposal to the Commission for comments or instructions.

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* The company's investment adviser will also be registered under the Adviser's Act and its underwriter registered as a broker-dealer.

In reviewing the proposal, the Commission may want to note particularly the fact that it envisions no limitation on the percentage of the portfolio of the foreign portfolio sales corporation that could be invested in foreign securities.* The staff representatives of both the State Department and the Federal Reserve Board question the desirability of omitting from the proposal a requirement that the company invest in U.S. securities. They point out that the basic purpose of favored treatment under the Internal Revenue Code for such a vehicle would be to encourage investment in U. S. securities and that the absence of any limitation on investments in foreign securities is inconsistent with that purpose.

The Treasury Department, however, has taken a strong position that there should be no such limitation. Their position is apparently based on the belief that a limitation would be construed by a foreign government as inconsistent with this Government's position that a foreign country should not require, as a prerequisite to the sale of shares of a mutual fund in that country, that a certain percentage of the assets of that fund be invested in securities of local enterprises. They are concerned that if such a limitation is included, other countries would adopt similar restrictions. The Treasury also feels that, as a matter of fact, most of the securities in the portfolio will be securities of American companies. Further, they feel we should not preclude the possibility that in the future it may be desirable to allow foreign securities investments. Finally, they point to a possible interpretation problem that such a limitation might cause under the O.E.C.D. code for Liberalization of Capital Movements.

So far as the Commission is concerned, the absence of a meaningful limitation on foreign securities investments can create difficulties or valuation. This problem, which is always difficult, could be compounded if the company invested a material portion of its assets in foreign

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* See page 4, para. 1. of the attached draft proposal.

securities. Even if the securities were listed on a foreign securities exchange, we would still be involved in the question of the adequacy of quotations. Related to this problem is the requirement of liquidity for open-end companies which could be impaired by substantial foreign securities investments. As to this problem, the Treasury Department staff points out that valuation and liquidity problems exist with respect to all open-end investment companies today - even where their portfolio contains no more than 10 per cent restricted securities - to the extent the market for portfolio securities is limited. Of course, the last position we would want to be in is one where we will be unable to fulfill foreign investors' expectations as to the scope and adequacy of our supervision of this new type of registered investment company.

Another matter, unrelated to the absence of any limitation on foreign securities investments, which the Commission may wish to consider is the fact that the corporation envisioned by the proposal will issue bearer shares. A few registered investment companies selling to foreigners already use this method although it does raise a number of questions arising under the provisions of the Investment Company Act relating to voting, election of directors, etc.

We would like to discuss the draft proposal with the Commission at the Commission's earliest convenience.

ASMOSTOFF:eb

ATTACHMENT

September 29, 1971

DRAFT PROPOSAL FOR A FOREIGN-OWNED PORTFOLIO SALES CORPORATION

Summary of Proposal.

To create a Foreign-owned Portfolio Sales Corporation (FPSC) to permit a special status of mutual funds selling only to foreign investors to register with the SEC and operate in the U.S. with tax benefits comparable to those available to offshore funds.

Objectives of Proposal.

(1) To bolster foreign confidence in the U.S. securities markets by extending SEC investor protection to foreign investors.

(2) To encourage sales of mutual funds investing in U.S. securities to foreign investors and thereby assist the U.S. balance of payments.

(3) To develop the U.S. position as a world financial center.

(4) To enable U.S. mutual funds and investment advisers to compete on a more equivalent basis with offshore funds.

Description of FPSC.

A special category of corporation would be recognized under a new section of the Internal Revenue Code of 1954. In order to qualify for the tax treatment provided in the new section, the corporation would be required to satisfy the following conditions:

(1) It would be a corporation incorporated under the laws of any of the States of the United States or the District of Columbia. Incorporation in the United States seems desirable for the following reasons:

(a) There will be greater assurance of investor safety where the entity is subject to United States control and regulation rather than investment through foreign tax havens with their inherent instability.

(b) Surveillance of the FPSC's activities and records will be facilitated by domestic incorporation, avoiding claims of secrecy and foreign law inherent in foreign incorporation.

(c) There is less likelihood of conflict under U.S. and foreign securities, corporate and tax laws.

(d) There would be increased data available to the SEC in its surveillance of market activity in the United States.

(2) The corporation must be registered under the Investment Company Act of 1940 and be in compliance with the regulations of the Securities and Exchange Commission. The corporation would generally be subject to the same SEC rules and regulations as domestically owned investment companies, including registration under the Securities Act of its securities, and the rules relating to the content of its portfolio and its investment policies.

(3) Except through the stage of incorporation, and prior to public sale, there would be no United States shareholders. The corporation would not be permitted to sell its shares to citizens or residents of the U.S., and if such persons acquire shares in the corporation, they would be automatically redeemed.

(4) Sales in the United States of the FPSC's stock to foreigners would not be permitted.

(5) The corporation would have only one class of stock which must be widely held. This requirement would be enforced by the SEC as part of the registration process.

(6) It is contemplated that the statutory requirements would incorporate, with appropriate modifications, the limitations on the income and portfolio of a regulated investment company under section 851(b) of the Internal Revenue Code (See Annex).

(7) United States margin requirements would be applicable to portfolio acquisitions by the FPSC.

(8) The FPSC concept does not contemplate the use of a partnership vehicle. The reason for omitting partnerships from the proposal is the difficulty that a partnership vehicle would have in conforming to the requirements of the Investment Company Act of 1940.

The FPSC would be permitted to engage in the following activities:

(1) There would be no limitation on the percentage of its portfolio that could be invested in foreign securities. However, as indicated below, dividends and interest (but not capital gains) from foreign securities would be subject to U.S. tax in order to avoid the use of U.S. as a tax haven and to discourage any preference for investments outside the United States.

(2) The corporation could issue bearer shares or arrange for bearer depository receipts for its shares. Appropriate procedures would be established for depositing the shares or receipts for voting and the exercise of other rights.

(3) The corporation would not be required to maintain its principal office outside the United States as offshore mutual funds are presently required to do in order to obtain favorable U.S. tax treatment. Accordingly, the restrictions contained in the present Treasury Regulations ("the ten commandments") would not be applicable to the FPSC and it would have much greater centralization of control over its operations, records, etc.

(4) The acquisition of foreign securities by the FPSC would not be subject to the Federal Reserve Voluntary Foreign Credit Restraint Program.

Tax Treatment of FPSC.

A new section of the Internal Revenue Code would provide special tax treatment for a corporation meeting the above requirements. In general, this new section would be intended to provide the equivalent tax treatment as presently enjoyed by offshore funds. The one important exception is with respect to income from foreign securities. In order to prevent foreigners from using the FPSC as a tax haven through which to purchase foreign securities, dividends and interest (but not capital gains) from foreign securities will be subject to U.S. tax when received by the FPSC even though they are not taxable in the case of offshore funds. In accordance with these general principles, the tax status of the FPSC and its foreign shareholders would be as follows:

(1) A 30% tax would be imposed on dividends and interest received by the FPSC on U.S. and foreign securities. The foreign tax credit would apply to foreign source income.

(2) There would be no capital gains tax on sales of U.S. or foreign securities by the FPSC.

(3) There would be no capital gains tax on sales of shares in the FPSC by its foreign shareholders. Similarly, there would be no withholding taxes on distributions by the FPSC to its foreign shareholders.

(4) The accumulated earnings tax would not apply.

(5) There would be no U.S. estate or gift taxes applicable to shares of the FPSC owned by foreign shareholders.

(6) The Interest Equalization Tax would not be applicable to acquisitions of foreign securities by the FPSC.

Management Companies and Selling Activities.

No special tax benefits will be made available to management companies, their U.S. investment advisers, or selling agencies. As a result of the FPSC's registering with the SEC, investment advisory contracts and related services will be required to meet SEC standards. Selling activities, including sales charges, will be subject to SEC rules and orders. In administering its rules and the issuance of exemptive orders, the SEC will take into account foreign selling practices and applicable foreign securities regulations.

Bank Participation

It is possible that under domestic banking laws, U.S. banks may not be permitted to organize or manage a FPSC even though under present law they may act as investment adviser to an offshore mutual fund. This is a special problem which merits further consideration. However, it should be noted that a recent proposal of the Federal Reserve's Board of Governors to allow bank holding companies to act as investment advisers to mutual funds may provide a solution to this problem.

REGULATED INVESTMENT COMPANIES

[¶ 4067] DEFINITION OF REGULATED INVESTMENT COMPANY

Sec. 851 [1954 Code] (a) GENERAL RULE—For purposes of this subtitle, the term "regulated investment company" means any domestic corporation (other than a personal holding company as defined in section 542) —

(1) which, at all times during the taxable year, is registered under the Investment Company Act of 1940, as amended (54 Stat. 789; 15 U.S.C. 80a-1 to 80b-2), either as a management company or as a unit investment trust, or

(2) which is a common trust fund or similar fund excluded by section 3(c)(3) of such Act (15 U.S.C. 80a-3(c)) from the definition of "investment company" and is not included in the definition of "common trust fund" by section 584(a).'

(b) LIMITATIONS—A corporation shall not be considered a regulated investment company for any taxable year unless—

(1) it files with its return for the taxable year an election to be a regulated investment company or has made such election for a previous taxable year which began after December 31, 1941;

(2) at least 90 percent of its gross income is derived from dividends, interest, and gains from the sale or other disposition of stock or securities;

(3) less than 30 percent of its gross income is derived from the sale or other disposition of stock or securities held for less than 3 months; and

(4) at the close of each quarter of the taxable year—

(A) at least 50 percent of the value of its total assets is represented by—

(i) cash and cash items (including receivables), Government securities and securities of other regulated investment companies, and

(ii) other securities for purposes of this calculation limited, except and to the extent provided in subsection (c), in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the taxpayer and to not more than 10 percent of the outstanding voting securities of such issuer, and

(B) not more than 25 percent of the value of its total assets is invested in the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, or of two or more issuers which the taxpayer controls and which are determined, under regulations prescribed by the Secretary or his delegate, to be engaged in the same or similar trades or businesses or related trades or businesses.

(c) RULES APPLICABLE TO SUBSECTION (b)(4) —For purposes of subsection (b)(4) and this subsection—

(1) In ascertaining the value of the taxpayer's investment in the securities of an issuer, for the purposes of subparagraph (B), there shall be included its proper proportion of the investment of any other corporation, a member of a controlled group, in the securities of such issuer, as determined under regulations prescribed by the Secretary or his delegate.

(2) The term "controls" means the ownership in a corporation of 20 percent or more of the total combined voting power of all classes of stock entitled to vote.

(3) The term “controlled group” means one or more chains of corporations connected through stock ownership with the taxpayer if—

(A) 20 percent or more of the total combined voting power of all classes of stock entitled to vote of each of the corporations (except the taxpayer) is owned directly by one or more of the other corporations, and