92d Congress, 1st Session - - - - - House Document No. 92-64, Part 3

INSTITUTIONAL INVESTOR STUDY REPORT
OF THE
SECURITIES AND EXCHANGE COMMISSION

VOLUME 3

CONSISTING OF THE FOLLOWING CHAPTERS:

CHAPTER VII.—OFFSHORE FUNDS

CHAPTER VIII.—PENSION-BENEFIT PLANS, FOUNDATIONS & EDUCATIONAL ENDOWMENTS

CHAPTER IX.—DISTRIBUTION AND CHARACTERISTICS OF HOLDINGS IN INSTITUTIONAL PORTFOLIOS

OF THE INSTITUTIONAL INVESTOR STUDY REPORT, BEING A STUDY AND INVESTIGATION OF THE PURCHASE, SALE AND HOLDING OF SECURITIES BY INSTITUTIONAL INVESTORS OF ALL TYPES, PURSUANT TO SECTION 19(e) OF THE SECURITIES EXCHANGE ACT OF 1934 (PUBLIC LAW 90-438, 91-410)

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CHAPTER VII

OFFSHORE FUNDS

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CHAPTER VII

OFFSHORE FUNDS

A. INTRODUCTION

One of the most spectacular developments in international financial markets since 1967 has been the growth in number and size of offshore funds.[1] However, very little specific information has been available on their aggregate size, and the volume and impact of their transactions in the U.S. financial markets and balance of payments. Nor has information been available on the degree of involvement of the U.S. financial community in offshore fund activities; these include its role in the establishment of the funds in question, acting as investment adviser, executing brokerage, and acting as custodian of the funds' securities and other assets. Hence this chapter, which touches briefly on many of the aspects of offshore fund activities.

1. Aims of the Chapter

A primary aim was to get an impression on the growth and magnitude of offshore funds' activity in the U.S. market and the organizational framework in which they operate. The approach taken on statistical data was two-fold: First, to ask U.S. banks and brokers that hold securities in the name of offshore funds to estimate the value of these accounts in terms of U.S. stock and other U.S. securities as of December 1967, December 1968, December 1969, and February 1970. This would give a rough idea of the value of offshore funds' total holdings of U.S. securities. Second, an attempt was made to get data from U.S. brokers on the monthly trading activity—gross purchases and sales of portfolio securities—of identified offshore funds in the U.S. market over a 26 month period, from January 1968 to February 1970.

The data collected was structured in such a way that it could be compiled and measured against data already published by the Treasury Department and Federal Reserve Board on all reported transactions with foreigners in long-term securities (both U.S. and foreign) in the U.S. securities markets. This permits an assessment of the importance of reported offshore fund activity in relation to all foreign activity in terms of impact on both (a) the financial markets and (b)

[1] An offshore fund is defined as a mutual fund, hedge fund, leverage fund, investment company or combination thereof that (a) is incorporated in a foreign country (generally, but not necessarily, a country offering tax advantages, such as the Bahamas, Bermuda, Netherlands Antilles, Switzerland, Luxembourg, Canada, etc.), (b) does all or most or a principal part of its selling to persons who are not U.S. citizens or residents, and (c) whose principal sales efforts are not aimed primarily at residents of the country in which the fund is legally incorporated. For example a fund established in the U.K. by U.K. citizens designed to sell primarily to U.K. residents would *not* be considered an offshore fund for the purposes of this Study. Neither would funds incorporated in France by French citizens (*sociétés d'investissement à capital variable*) designed primarily to be sold to French investors. However, a subsidiary or national fund established by an offshore fund or offshore fund management organization in order to operate and sell shares within the framework of a given foreign country's laws and foreign exchange regulations would be considered as an offshore fund for the purposes of this Study.

the balance of payments. The Study tries to assess the importance of offshore fund activity in U.S. stock transactions in relation to selected U.S. institutional investor groups.

In addition, replies to the questionnaire (Form I-73) provide supplementary data on the number of identified offshore funds by their size and trading activity; by their affiliation with U.S. investment advisers, brokers, and custodians; and by the number of U.S. banks and brokers involved in executing transactions or acting as custodian for offshore funds.

2. Problems in Acquiring Data

From its inception the Study knew that it would not be able to identify all offshore fund activities in the U.S., nor was it possible with any precision to attempt a detailed sample. When the Study began, no reasonably complete list of offshore funds existed, nor were addresses readily available. Complete records of the offshore funds' activities are held by management companies domiciled outside the U.S. A decision was made not to mail questionnaires outside the U.S., but rather to use data that could be obtained from the U.S. financial community.

Many respondents to the questionnaire stated that they faced considerable difficulties. Custodians very often had to reconstruct the value of offshore funds' holdings for the dates in question. To the extent that the custodians were able to identify accounts as being offshore funds, the data give a roughly accurate measure of the value of offshore funds' holdings in the U.S. of U.S. stock and other U.S. securities.

Data on specific monthly transactions of offshore funds proved more of a problem. Brokers could report the exact value of transactions by identifiable offshore fund accounts. The problem came in making the identification. Not all brokerage houses keep their records in the same way, and few if any segregate offshore fund accounts in a single category.

In some cases it was necessary for brokerage houses to review their account lists or query their salesmen. Some brokerage houses that transacted or cleared for others claimed to be ignorant of the identity of accounts.

To compound the difficulties, many brokers receive orders from offshore funds in the name of a custodian bank, or a European financial institution, or a nominee. Hundreds of millions of dollars of business were transacted this way without the brokers' records indicating the identity of the offshore funds for which they were executing transactions—or even if they were dealing for an offshore fund or for a foreign account.

3. Building in Cross-Checks

The initial mailing of the questionnaire went to 250 banks, underwriters, and brokers known to be active internationally. Those who acted as custodians were asked to give an estimate of the total value of holdings of U.S. stock and other U.S. securities in the account and to identify the brokers who transacted on behalf of the off-

shore funds (that is, the brokers who delivered securities to the custodian on behalf of the offshore fund).

Brokers were asked to give the value of monthly transactions that they knew were executed for offshore funds and to identify custodians to whom they delivered or from whom they obtained the securities. Investment advisers who indicated to the Study that they had offshore fund accounts were asked to identify both the brokers and custodians utilized.

This gradually turned up names of new respondents; the list of those queried grew from 250 to 480. About 195 brokers initially reported having no offshore fund accounts. Cross-checks and the cooperation of other respondents gradually helped to identify many of the offshore fund accounts held by these brokers. Eventually 310 brokers reported some offshore activity. However, about 170 others stated that they had no offshore fund accounts, although roughly 20 of these were specifically identified by custodians or investment advisers as having transacted trades on behalf of offshore fund accounts. Because of the difficulty in obtaining data, the results of the Study may consistently understate the volume of offshore fund activity in the U.S. market.

4. Other Elements in the Study

The Study's questionnaire was supplemented by over 50 interviews with members of the financial community, and hundreds of telephone calls. In addition, the Study collected prospectuses of over 100 offshore funds and consulted professional articles on organizational, institutional, and operational aspects of offshore fund activity. Much of this is set down in what follows.

5. Why an Offshore Fund?

While there may be many reasons for a U.S. investment adviser to form an offshore fund, one of the principal reasons is likely to be avoidance of Commission registration and disclosure requirements. Such avoidance is possible even for a domestic entity if its outstanding securities are beneficially owned by not more than 100 persons and it does not presently propose to make a public offering of its securities. Such an entity is deemed by section 3(c)(1) of the Investment Company Act of 1940, 15 U.S.C. § 80a–3(c)(1), not to be an investment company for purposes of that Act, and therefore the registration and other provisions of that Act would not apply to it. Indeed, it is this provision upon which domestic limited investment partnerships (so called "hedge funds") rely for their exemption from registration under the Investment Company Act.

A domestic fund which does not desire to limit itself to the requirements of section 3(c)(1) must register with the Commission. A foreign company, however, cannot; section 7(d) of the Investment Company Act, 15 U.S.C. § 80a–7(d), prohibits any investment company not organized or otherwise created under the laws of the United States or of a State from using the U.S. mails or any means or instrumentality of interstate commerce in connection with a public offering

of any security of which such company is the issuer.[2] It is important to note that the literal words of the statute do not require the public offering to be in the United States. If the jurisdictional means are used, the Commission has jurisdiction. However, the words "public offering" have been interpreted by fund managers to mean an offering to the American public. Historically, at least in the non-investment company area, the Commission has generally refrained from requiring registration of public offerings made outside the United States to non-Americans under circumstances where the securities will come to rest outside the U.S.[3]

In order to avoid registration under the Investment Company Act and the Securities Act of 1933, U.S. investment advisers who have established offshore funds generally maintain, therefore, that any use of the U.S. mails or other instrumentalities of interstate commerce in connection with fund operations is not a use in connection with the offer or sale of fund shares, and neither the fund nor its shares are registered under the Investment Company Act or the Securities Act. Furthermore, the offshore fund prospectus will usually state that shares of the fund may not be sold to citizens or residents of the United States, and will make provisions for compulsory repurchase of the fund shares should a U.S. citizen become their owner.[4]

B. STRUCTURE OF THE OFFSHORE FUND INDUSTRY

The structure of the U.S. mutual fund industry is set out in part A of chapter IV. Funds publicly sold in the U.S. are usually domiciled in the U.S., are subject to U.S. laws and taxation, have a principal U.S. underwriter and U.S. investment adviser, and generally work within a framework where considerable information is available about their activities.

The structure of the offshore fund industry, however, is very different and ordinarily more complicated. The offshore fund is domiciled outside the U.S., generally in a country which has a relatively low level of taxation. The fund's management company is also domiciled outside the U.S., but for administrative reasons (such as language and communication), it may be domiciled in a country different from the fund's country of domicile. The management company usually has a contract with a U.S. investment adviser to provide it with advisory services. The U.S. adviser may own a large part of the management company. The management company may also have contractual arrangements with European investment advisers to provide it with advice concerning the fund's portfolio transactions in European securities. The fund's principal underwriter outside the U.S. may be a

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[2] Section 7(d) empowers the Commission, upon application by the foreign entity, to issue an order permitting it to register and publicly offer its securities, if the Commission finds that it is both legally and practically feasible to effectively enforce the provisions of the Investment Company Act against the foreign entity and that the issuance of such an order is otherwise consistent with the public interest and the protection of investors.

[3] Securities Act Release No. 4708 (July 9, 1964).

[4] On June 23, 1970, the Commission issued "Guidelines Concerning the Applicability of the Federal Securities Laws to the Offer and Sale Outside the United States of Shares of Registered Open-End Investment Companies." (Investment Company Act Release No. 6082). In this release, the Commission noted that "[F]oreign sales of non-investment company securities are to be distinguished from sales of investment company securities." The Guidelines were designed to "insure that substantially the same disclosure required by the federal securities laws for American investors will also be generally available for foreign investors who are purchasing shares of registered American investment companies."

U.S. broker-dealer, or the European affiliate of a U.S. broker-dealer; European financial institutions may also be involved in the underwriting function. Indeed, European underwriters would probably be utilized if a large initial offering of shares was made.

The offshore fund will use a U.S. broker-dealer to purchase and sell U.S. securities for it. It will also use a custodian bank to hold the securities purchased, to deliver those sold, and possibly to redeem its shares if the management company does not fulfill this role. Auditors and law firms, both U.S. and foreign, may have to be retained.

The offshore fund, its management company and its U.S. investment adviser will need to observe requirements of U.S. tax laws to benefit from provisions of the Foreign Investors Tax Act of 1966. Moreover, the foreign countries in which the offshore funds sell their shares may also have regulations, taxes and exchange controls that will need to be taken into account.

C. AN OVERVIEW OF THE OFFSHORE ADVISORY INDUSTRY

The relationships and forms an offshore endeavor take can differ considerably based upon the primary domestic activities of the investment adviser. The composition of the offshore advisory industry is diverse. The initiative for establishing most offshore funds probably comes from the offshore funds' investment advisers or their U.S. affiliates. In some fewer cases, the initiative may also have come from European financial institutions that invest in the U.S. market. There are also some offshore funds, including the largest complex, where the management is largely composed of American citizens living abroad.

Most of the investment advisers can be considered to be the founders of the offshore funds. There are some cases, however, where a management company first formed a fund and then sought advisory services. The investment adviser might, or might not, be registered with the Commission. He usually is closely affiliated with or has experience running a similar or related U.S. type operation, and he might, or might not, be constrained in charging performance fees because of Commission registration or affiliation with a member firm of the New York Stock Exchange ("NYSE") (which limits total remuneration to four percent of the net value of assets under management).

Most U.S. advisers manage the entire portfolio, but some do not. Some funds, often those which invest in other funds, set up captive proprietary funds.[5] One large fund invests its assets in several "prop" funds, each with its own adviser. The management company in these cases might receive profits or fees from the proprietary funds and from the parent fund investing in the "prop" funds. This, of course, raises questions of pyramiding fees ultimately paid by the individual investors in the parent fund.

Some funds, sometimes those with European financial institutions closely linked to the management company, may change the U.S. investment adviser periodically. In these cases, as opposed to those in which the U.S. investment adviser is closely associated with the management company and the fund, there appears to be an arm's length relationship between the U.S. investment adviser and the fund, based

[5] A proprietary fund is one that is part of a management company complex or a subfund in which a parent fund invests a portion of its assets.

upon the performance of the investment adviser in managing the portfolio.

The U.S. investment adviser may exercise complete discretionary authority over the portfolio, that is, he may actually determine purchases and sales and portfolio composition without any reference to the management company (which would, however, with the bank custodian be informed of the transactions). Or, the U.S. investment adviser might cable "suggestions" for portfolio transactions to the offshore management company. The Foreign Investors Tax Act of 1966 permits the investment adviser to exercise discretionary authority in portfolio management. However, a management company domiciled abroad might, for tax purposes, wish to establish that it is actually functioning in a management capacity (and effectively earning non-U.S. source income from the fund), and so require that the U.S. investment adviser submit its recommendations to the management company for approval.

1. Relationships With Investors

The relationship between the investment adviser and the ultimate investors (that is, the purchasers of fund shares) may be close or it may be non-existent.

Where the investment advisory firm has been retained in an arms-length transaction by a management company, it is likely that it has little direct contact with the foreign investors in the fund. It has been hired to manage all or a portion of the fund's portfolio, but the link to the ultimate investor (through the management company, the fund, and the underwriter, foreign salesman, or financial institution) may be remote.

The situation may be different if the fund is a high risk, leveraged, non-diversified hedge fund (akin to a non-registered investment partnership in the U.S.) requiring a considerable initial investment.[6] These funds are for the more sophisticated investor who may already have had dealings with the investment adviser, or heard of the investment adviser by reputation, or through a sales representative or foreign financial institution. Indeed, many U.S. hedge fund operators have established offshore hedge funds for their foreign clients.

Wealthy individuals and foreign institutional investors with discretionary accounts are approached directly outside the U.S. by representatives of management companies or investment advisers. This is true whether the fund is a hedge fund requiring a large initial investment or a fund connected with a large, well known, regulated U.S. underwriter or financial institution.

Where an offshore fund is affiliated with a U.S. financial institution or underwriter, a distribution network may already exist that can be utilized, either through correspondent European banks or foreign branches of the U.S. institution.

For example, First National City Fund has as its underwriters Hill, Samuel & Company, a large British merchant bank and Merrill Lynch,

[6] For example, the Harbor Isle Corporation, an open-end hedge fund organized in the Netherlands Antilles, requires a minimum investment of $100.000.

Where examples are based on specific offshore fund practices, with the fund identified by name, the information unless otherwise stated will have been drawn from a printed prospectus or offering circular. The funds chosen have been selected because they seem representative of the practice being discussed.

Pierce, Fenner and Smith and Securities Underwriter Limited. The fund is organized under Swiss law. It was organized by the management company, First National City Fund Management Company, S. A. of Geneva, which contracted with First National City Bank, New York, and Pictet & Cie, a private Swiss investment bank in Geneva to provide investment recommendations on securities of U.S. and European issuers respectively. The investment advisory contracts have a stated period of three years, may be renewed yearly thereafter, and are subject to cancellation at any time by either party. Shares were originally issued in December 1968, for $25.15 per share. In cases like this, it seems unlikely that the investment adviser would have any direct relationship with a small purchaser of a share of the fund.

2. Constraints on Activities

Many U.S. investment advisers claim they feel constrained not to discuss offshore fund activities directly in the U.S. with a prospective foreign client or to communicate with him from the U.S. To do so, the U.S. investment advisers fear, would raise serious questions with respect to their status under the Foreign Investors Tax Act of 1966 and also raise questions under the federal securities laws.

For the same reasons, most U.S. banks, underwriters and brokers active in offshore fund activities as investment advisers or in other capacities claim that they do not even have copies available in the U.S. of the prospectuses of the offshore funds with which they are connected, even though by their terms these prospectuses may specifically prohibit sales to U.S. citizens and residents and only permit sales to non-resident foreigners.

D. TYPES OF OFFSHORE FUNDS

If anything, there are probably as many diverse types of offshore funds as there are species of funds found in the U.S., perhaps even more. This is due to the regulatory environment which permits offshore funds (depending upon where domiciled) to adopt whatever structure might seem most advantageous to the investment advisers.

Many of these funds could not meet Commission registration requirements and sell publicly in the U.S. (because of their high performance fees, inadequate disclosure, infrequent valuations, etc.) Direct operations by these funds in the U.S. would also be constrained because of tax burdens more onerous than those imposed offshore. In general foreign investors, in the absence of double taxation agreements, pay a flat 30 percent withholding rate on dividends and interest earned in the U.S. and no capital gains tax at all. This permits the offshore money manager greater latitude in his portfolio management decisions.

It also gives the individual foreign investor a greater choice of investment instruments than he would find in the U.S. if he dealt with a U.S. mutual fund. It permits him to benefit from certain tax advantages that are intended to be granted to foreign investors and from a few others open primarily to investment through foreign institutional investors. At the same time, offshore funds allow foreign investors to obtain professional U.S. management of their investment. U.S. financial institutions can be associated with offshore funds, pri-

marily as investment advisers. They can thereby promote the sale of U.S. securities abroad. It may at the same time strengthen foreign correspondent relationships.

Some offshore entities are hedge-leverage funds of the type that would not be allowed to publicly offer their shares in the U.S. Because of the absence of capital gains tax considerations, rapid turnover of their portfolio is not inhibited. These funds also charge a performance fee. The promise of such a fee has permitted the entry of many small offshore funds into the industry during the late 1960's. In this respect they have increased competitive elements in the system.

The payment of such fees, however, has also raised certain problems. For example, while every manager of more than one portfolio is presented with the difficult problem of allocation of portfolio decisions (see section J of chapter IV), the problem can be considerably aggravated where the U.S. manager also advises an offshore fund from which he may realize a fee for a maximization of portfolio performance substantially higher than that paid by the U.S. registered company he is also managing.[7]

1. Types of Offshore Funds Not Considered by the Study

This chapter is designed to assess the overall magnitude and impact of offshore fund activities on the U.S. securities markets. However, it will not consider some of the more esoteric type offshore funds. These are omitted not because they lack interest, but rather because they do not have a direct impact on the U.S. securities market (although to the extent they are successful, they may divert savings that would otherwise be invested, through funds or directly, in U.S. securities).

The offshore funds that will not be directly considered include those listed below. Statements made concerning them are intended to be descriptive only.

Real estate funds. These funds invest predominately in U.S. real estate. There are several such funds. One of these, United States Investors Fund, managed by Gramco Management, Ltd., dominated the field. However, this fund has recently encountered liquidity problems and has had to suspend redemptions.

Aside from what would appear to be short-term investments in U.S. securities or money market instruments, real estate funds seems to divert savings from the securities markets into real estate investments and at the same time to increase borrowing in the U.S. to the extent that additional demands are made on the U.S. mortgage market. Foreign subscriptions would have a positive effect upon the U.S. balance of payments and generate additional cash flow to the real estate market.

These funds have been subject to criticism for driving up the cost of certain types of real estate, primarly commercial and industrial, and for valuation methods and insufficient liquidity (i.e., ready marketability of assets) to meet redemption demands. The funds generally claim to keep a high percentage of assets (20–30 percent) liquid in order to meet redemptions, but in the case of Gramco, available liquidity was inadequate to meet redemptions.

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[7] The Investment Company Amendments Act of 1970, Pub. L. No. 91–547, signed into law by President Nixon on December 14, 1970, attempts to deal with this problem. See the discussion in sec. G.1.a below.

Foreign exchange arbitrage funds, whose profits depend upon the investment advisers' skill in foreign exchange arbitrage.

Funds that invest directly in oil and gas ventures, leases and prospecting, as distinct from those that invest in the securities issued by companies that undertake these type operations.

Funds that invest in international commodities, for example, coffee, tea, tin, and cocoa.

Funds that invest in objets d'art. Several of these are being formed in the U.S. and offshore.

Funds that invest exclusively in foreign securities which are being formed in the U.S. and offshore.

2. Characteristics of Offshore Funds That Are Considered

The funds that are considered are described below. The various components have some common characteristics, particularly the involvement of a U.S. investment adviser, a U.S. custodian or subcustodian bank, and U.S. brokers. In addition, U.S. underwriters in their foreign operations may sell shares on behalf of the funds.

Beyond this, however, the structure of each individual fund is usually a reflection of the structure, aims, and organizational relationships of the U.S. or foreign bank, broker, underwriter, or investment adviser responsible for launching the particular fund in question. The funds seem to fall into general categories reflecting or related to the activities of the fund's U.S. affiliation.

a. Hedge funds

These are funds with management techniques that resemble those of private limited investment partnerships in the U.S. For purposes of description, a U.S. type fund is contrasted with its offshore counterpart.

Typically, in the U.S., a hedge fund would not be registered with the Commission as an investment company, claiming exclusion from the Investment Company Act under section 3(c)(1) as an issuer not making a "public offering," the shares of which are held by 100 or fewer beneficial owners. They are generally associated with a higher degree of risk than the registered U.S. mutual fund or larger offshore fund that is run along more conventional lines, and which is sold through salesmen or brokers to anyone with the price of a single share.

Hedge funds, whether on shore or off, often deal in short selling, puts and calls, leveraging, and other techniques associated with sophisticated and speculative money management aimed at high performance. The investment managers or general partners who run the funds are compensated by a performance fee based on the increase in net asset value.

In the U.S., each investor is a limited partner. The investment adviser is the controlling general partner. A large initial investment, outside the reach of the small investor, is usually required.

How does an offshore hedge fund differ?

The offshore hedge funds are not restrained from offering publicly. Prospectuses and offering circulars are common, and discuss organization, management, investment advice, operations, capital stock, division of profits, and include financial statements.

An unregistered U.S. investment partnership might have a limited partnership agreement covering the main points mentioned in the printed offshore circular. It would not contain what is usually found in the offshore circular—an offer to subscribe to shares to be completed by the prospective purchaser stating that he has received and reviewed the offshore fund's offering circular.

Because of foreign investor preferences and foreign laws governing incorporation, offshore hedge funds are formed as corporations rather than limited partnerships. The role of the general partner (that is, portfolio manager) is usually assumed by an investment adviser closely related to or identical with the founders of the fund.

A representative statement of purpose and investment policy of an offshore hedge fund is set out in appendix A.

Many U.S. based investment advisers or money managers (whether or not registered with the Commission) associated with limited partnerships in the U.S. have established offshore hedge funds to service existing foreign clients or to attract new ones. Foreign financial institutions also have established offshore hedge funds.

The offshore hedge funds can offer a U.S. manager the chance to build up equity in the offshore fund with eventual U.S. tax computed at the capital gains rate or perhaps not at all. The payment of the performance fee is usually linked to a separate category of shares (class B) issued to a limited number of persons connected with the establishment of the fund. This class B security would receive a given percentage of the profits of the funds that would otherwise be initially applicable to ordinary (class A) shareholders.

One recent trend has been for the management to offer class B shares to foreign financial institutions making substantial subscriptions to (or bringing large subscribers to) the fund in the form of purchases of ordinary shares. In return for their assistance and/or participation, the foreign institutions are in effect offered a share of the management profits. Some hedge funds established by U.S. brokerage houses apparently sell directly to wealthy foreign clients through representatives stationed abroad. Foreign institutional investors including those with discretionary accounts reportedly receive frequent solicitations.

Another peculiarity of hedge funds, both domestic and offshore, when compared to registered open-end investment companies, is the infrequency of valuation of their portfolios. Subscribers may be able to subscribe to and redeem shares periodically, but not daily. Quarterly redemption provisions seem fairly frequent.

Hedge funds, at least those requiring a substantial minimum investment, do not as a rule require a sales charge. There is frequently a redemption charge, usually in the range of 1 percent of the net asset value per share.

b. Funds that invest in hedge funds

The I.O.S. sponsored Fund of Funds has utilized proprietary funds that have hedge fund characteristics.

In addition, there is at least one fund established by several European institutions that invests in hedge funds.

The objectives of one such fund are set forth in appendix B.

This fund has two classes of stock. The fund is authorized to issue 2,000 shares of class A stock to individual persons subscribing to these shares at an initial offering price of $10,000 per share and 2,000 shares of class B stock at $10 a share for institutions or persons responsible for subscriptions of $500,000 or more of class A stock. The class B stockholders would receive 10 percent of the annual increase in aggregate net worth of the Fund in return for a disproportionately smaller contribution to the assets of the fund. The investment adviser receives an annual fee of ½ of 1 percent of average net asset value per year. In addition, the Fund (through its investors) also pays those performance fees charged by the hedge funds in which the fund invests.

c. Funds with hedge fund characteristics

As is often the case in a rapidly growing and changing field, some funds defy strict categorization. Some seem to offer highly aggressive management similar to that expected from a hedge fund, with attendant performance fees or "adviser's incentive fees" but accept a much smaller initial investment.

The investment objectives and policies of such a fund are set out in appendix C. This fund has an adviser associated with a U.S. mutual fund. Where it and similar offshore funds differ from other hedge-type funds is (1) the size of the initial investment can be small, $500 and (2) sales charges are required, usually ranging from 8.75 percent for an investment less than $25,000 to 1 percent for an investment over $1 million. The fund allows for redemption at any time with no fee imposed.

d. Funds affiliated with banks

Many large banks, both domestic and foreign, are engaged in offshore fund activities. In Continential Europe, many banks have had their own in-house mutual funds for years. Indeed, some of these banks have several funds, with breakdowns by class of industry or by geographic region, offering a range of funds to investors with different objectives.

Some of these funds can properly be classed as "foreign national," rather than offshore, for example, funds established by French banks to be sold primarily to French citizens. Prior to the re-establishment of exchange controls, these funds were free to invest a large percentage of their assets, up to 70 percent, in foreign securities. Some did invest heavily in foreign securities, but their principal sales effort was domestic, with cash flow coming from domestic French investors.

Several large, powerful Swiss banks sponsor investment funds. Because of the unique role of Switzerland receiving heavy flows of foreign capital, some Swiss bank fund data is included in the statistical section. In each case this was done after the particular institution was identified by respondents to the Study as seeming to qualify under the Study's definitions.

Several major U.S. banks have connections with offshore funds through affiliate or subsidiary relationships.

The investment policy of the bank affiliated funds is generally conservative. See appendix D.

It is usual for the bank connected funds to contract with the affili-

ated bank for investment advice. Not infrequently, a European bank is named to supply investment advice for European issues.

In general, fees charged by the bank associated funds appear lower than those charged by funds not so affiliated. In the case of the First National City Fund for example, the management companies receive a fee of 0.5 percent per annum and a commission of 5.4 percent of the net asset value per fund share purchased, most of which in the initial issue went to the underwriters. For bank affiliated funds there are often relatively small redemption fees.

Some bank funds also include provisions for a performance fee measured against some index of stock market performance. The performance fees charged by bank funds generally are lower than those charged by the offshore hedge funds.

The U.S. banks concerned, or their affiliates, are usually named as custodians, which yields a further source of income. The banks acting in the capacity of investment advisers are in a position to allocate the fund's portfolio brokerage. This allocation may be related to research, preferential executions and advice, and compensating balances from the brokerage houses in return for the bank fund's business.

The offshore funds with bank affiliations would seem well placed through the banks' client and correspondent relationships to sell their securities in a wide network of outlets, and to further strengthen their foreign relationships, that could in turn lead to business in other sectors of the banks' operations.

As noted in chapter V, banks in the U.S. are subject to the Glass-Steagall Act. Offshore funds which retain U.S. banks as advisers are free from these restraints and have more leeway, just as would an Edge Act Corporation [8] affiliated with a U.S. bank.

Some observers claim that offshore funds affiliated with banks are well suited in terms of sales and distribution to tap the growing market of middle class savers and investors. Their names are well known and many are readily associated with U.S. management. Because of existing correspondent relationships or branches abroad, it is not necessary for them to construct from scratch a sales distribution system; one already exists. Because the infrastructure and business relationships are already established, operating costs could be lower than for an offshore fund of comparative size without the same advantages.

Indeed, foreign banks which frequently function as underwriters and brokers as well as collectors of savings have long been active in an investment advisory—investment fund capacity, frequently investing the discretionary accounts of their clients in mutual funds and other investment outlets.

These foreign financial institutions, rather than completely surrendering control of assets under their management, appear to be increasingly interested in seeking a *quid pro quo*, either through obtaining management shares in offshore funds sponsored by U.S. investment advisers or in setting up their own affiliated offshore funds.

Frequently, this is handled in a consortium arrangement. A recent manifestation is the Security and Prosperity Fund, S.A. (SEPRO); sponsored by the Credit Swiss and Swiss Bank Corporation (two leading Swiss banks) the U.K. based Save and Prosper Group, Lim-

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[8] The Edge Act, codified as 12 U.S.C. §§ 611–631, provides for the establishment of international banking and financial corporations operating under Federal supervision.

ited (the largest mutual fund group in the U.K.) the Societe General (one of the largest French commercial banks) and Bancio di Roma per la Svizzera (a Swiss affiliate of one of the largest Italian banks).

The two investment advisers to SEPRO are (1) a European research organization—investment advisory firm whose shareholders include 16 European, Canadian, and U.S. banks and (2) one of the largest U.K. investment banks.

The objectives and policies of SEPRO are highly international as can be seen from its prospectus, reproduced in part in appendix E.

This fund charges a ⅔ of 1 percent net asset value fee (computed quarterly) and a 5 percent "incentive" fee (to the advisory company) on annual appreciation in net asset value. The advisory company in turn pays the fees due to the investment advisers. When there is a decrease in net asset value per share, an amount of 5 percent of the decrease is carried forward from year to year and offset against future incentive fees.

A share in SEPRO costs $10, (minimum purchase, $1,000), of which 6 percent (that is, 60 cents per share) is deducted as a sales charge. Of the sales charge, 35–40 cents (that is, 3.5–4 percent) is paid in commission to the placing syndicate.

e. A foreign bank fund registered in the U.S.

An interesting twist to offshore funds is a new fund, (*not an offshore fund*), SoGen International Fund, Inc., incorporated in Delaware and registered with the Commission. SoGen is managed by an affiliate of a major French Government owned bank, the Societe General. SoGen's objective is long-term capital growth by investing primarily in common stocks of companies owned and operated in the U.S. and elsewhere in the free world. See appendix F.

The fund's maximum sales charge is 4.25 percent. The related investment advisory corporation will receive 6/10 of 1 percent per annum of the net asset value. There is also a sub-advisory agreement with a U.S. broker, who is paid a percentage of the value of the fund's net asset value on a descending scale in terms of assets under management, ranging from 0.5 percent down to 0.1 percent of assets.

The sub-advisory agreement provides that if the broker executes transactions on behalf of the fund, his advisory fees are reduced by an amount equal to 50 percent of the amount paid in brokerage commissions.

It is inconceivable that at least some offshore funds have not dealt in foreign currency transactions, selling a foreign currency forward if a foreign currency devaluation were feared and buying it forward if an upward revaluation were anticipated. While the Study has not obtained any information in this respect, the SoGen prospectus, set forth in part in appendix F, describes how this might be done.

f. Funds affiliated with mutual fund management companies

Many offshore mutual funds are affiliated with mutual fund management companies that have "on shore" operations in the U.S., Canada, U.K., and elsewhere. These offshore funds generally fall into two categories.

(1) *Offshore funds that invest directly in the shares of domestic mutual funds.*—There are a few offshore funds that invest directly

in the shares of the affiliated mutual funds. Each dollar invested in the offshore fund is invested in the domestic fund.

Where these are domestic U.S. funds, they are registered with the Commission and publicly offered. The objectives of the offshore fund are of course the same as those of the U.S. fund. There is no separate portfolio management. Typically, there would not be a pyramiding of management fees. See appendix G.

The sales charges on the purchase of these offshore funds resemble the pattern found in the U.S., that is, from 8.80 percent for investments up to $25,000, with the sales charge gradually decreasing to 1.25 percent on amounts of $1,000,000.

(2) *Separate offshore fund operations associated with domestic mutual fund managers.*—There are many U.S. and foreign mutual fund managers who run domestic mutual fund operations and who have set up offshore funds.

These will sometimes keep the association with U.S. or foreign management obvious from the name of the fund, but run a separate portfolio for the offshore fund.

The investment policies of these type funds appear, in general, to be more conservative than the hedge funds and somewhat more venturesome than the bank affiliated funds. For examples, see appendix H.

(3) *Fees.*—In general, the offshore funds affiliated with domestic mutual fund management companies charge an annual management fee of roughly ½ to ⅔ of 1 percent of net asset value, computed daily, weekly or quarterly, plus an incentive fee, that is, a performance fee of from 5 to 15 percent of the annual increase in net asset value, usually, but not always, measured against the increase in some standard market index such as the Standard and Poor's Stock Price Composite Index (500 common stocks).

There are also sales charges, frequently depending upon how shares are sold. If an underwriting group or sponsoring group places the shares during an initial offering, or in later offerings, a fixed fee, usually 5 to 6 percent of the purchase price of an individual share, goes to the underwriting group members which place the shares as commission. A distinction is made between the chief underwriters, or sponsoring bank, and other members of the placing or underwriting group.

Where the fund shares are not underwritten, the purchaser pays a sales charge to the salesman, broker or fund sales company depending upon the amount of his investment. Few funds have identical charges.

The following schedule is representative. Some funds charge more, others charge less.

Amount of Investment	*Sales Charge (percent)*
Up to $25,000	8.5
$25,000 but under $50,000	6.0
$50,000 but under $100,000	4.5
$100,000 but under $250,000	3.0
$250,000 but under $500,000	2.0
$500,000 and over	1.0

Some funds charge a fee for redemption of shares in the range of 1 percent; others make no charges for redemption.

The above sketch is not all inclusive, but is intended to give some flavor of the different varieties within the category.

There are also "no load" funds on which there is no sales charge to the investor.

g. Funds of funds

Section b above discussed a fund that invests in hedge funds. There are others, including one of the largest, that invest in other funds.

For example, the Capital Growth Fund of the Bahamas has six wholly-owned subsidiary investment funds. In addition, it purchases the shares of U.S. registered mutual funds. It utilizes independent investment advisers active in managing U.S. mutual funds, placing each under contract to manage a given trust for a stated period. Each of the trusts has the authority to borrow investment capital, using its assets as collateral, up to 54 percent of total assets. The management company, New Providence Securities of Switzerland, receives a 1 percent per annum fee of the fund's gross assets. Sales charges are from 8.5 percent to 1 percent, depending upon the size of the investment.

Fund of Funds (FOF) one of the largest and perhaps best known offshore funds, also falls into this category. It invests heavily in its own "prop funds," charges annual and performance fees, and engages in other activities such as lending securities from the "prop funds" to other firms that also earn money for the management company.

Some flavor of Fund of Funds' activities can be gleaned from an I.O.S. prospectus, reproduced in part in appendix I.

The Commission has expressed opposition to funds of funds, that is, mutual fund holding companies. This opposition was based on the layering of costs to investors, including advisory fees, two or more layers of administrative expenses, a sales load on a sales load and extreme skepticism about the utility of the fund holding company as an investment vehicle.[9]

The Investment Company Amendments Act of 1970 places substantial limitations on the creation and operation of foreign fund holding companies owning shares of United States registered open-end companies by amending section 12(d)(1) of the Investment Company Act to provide—

> It shall be unlawful for any registered open-end investment company (the "acquired company"), any principal underwriter therefor, or any broker or dealer registered under the Securities Exchange Act of 1934, knowingly to sell or otherwise dispose of any security issued by the acquired company to any other investment company (the "acquiring company") or any company or companies controlled by the acquiring company, if immediately after such sale or disposition—
>
> (i) more than 3 per centum of the total outstanding voting stock of the acquired company is owned by the acquiring company and any company or companies controlled by it; or
>
> (ii) more than 10 per centum of the total outstanding voting stock of the acquired company is owned by the acquiring company and other investment companies and companies controlled by them.

A similar prohibition would be imposed on the acquisition by unregistered off-shore investment companies of shares of registered closed-end companies by prohibiting any investment company and any company or companies controlled by it from purchasing or otherwise acquiring any security issued by a registered closed-end investment company if immediately after such purchase or acquisition the acquiring company, other investment companies having the same investment adviser, and companies controlled by such investment companies, own

[9] *Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966), 307–322.

more than 10 per centum of the total outstanding voting stock of such closed-end company.[10]

h. Other offshore funds

The above enumeration by no measure exhausts the range of funds, nor will this chapter attempt to encompass those remaining. Again by way of example, they include (1) the Nassau Fund Limited, comprising a Bahamian management company subsidiary of Deltec Panamerica, S.A., which obtains investment advice from an advisory council composed of four U.S. investment banking firms, (2) funds which issue debt at the same time as they issue shares, building on leverage, and (3) at least one fund that will concentrate on equity participation in promising young companies that have not yet gone public.

E. COMPENSATION AND DISTRIBUTION TECHNIQUES

1. Compensation

Aside from management fees, performance fees, sales charges and redemption fees (where these are applicable or charged), various types of indirect compensation are found in connection with offshore funds.

A bank being considered as a custodian by a fund might be asked about the size of the credit line it would be willing to make available.

A fund in allocating brokerage will be concerned about the quality of research and execution that it receives.

Directing brokerage has also been a means for rewarding the broker or his overseas affiliates for bringing in subscribers. Also, some funds permit firms that generate large subscriptions to purchase shares in the equity of the management company or in that class of security which profits from the proceeds of the performance fees.

A countertwist reportedly ahs been for the fund's management company or investment adviser to permit sponsoring institutions bringing large subscriptions to the fund to direct fund brokerage or "suggest" that it be given to a specified broker-dealer. The broker-dealer is told by the fund that the brokerage in question (representing a proportion of the fund's assets brought in by the sponsoring institution) is attributable to the sponsoring institution.[11] In return for this, the sponsoring institution might receive brokerage when its country's securities are purchased, a place on an underwriting syndicate, banking balances from the brokerage house, research, etc.

2. Distribution

Sales generally seem to follow four general patterns:

(i) Door to door selling to all income groups by the sales organizations of some funds, with particularly aggressive sales techniques. These have engendered considerable hostility in some countries where the funds are sold.

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[10] The Investment Company Amendments Act would also allow the creation and operation of registered fund holding companies but only if they charge a sales load of no more than 1½ percent and subject to other conditions.

[11] Indeed, if the portfolio velocity of the fund is high, the fund brokerage generated might be greater than the brokerage generated by the portfolio when it was advised by the foreign institution.

(ii) More sophisticated direct approaches by foreign based sales representatives of the investment adviser or affiliates to wealthy individuals and clients.

(iii) Institutional sales, with financial houses placing funds under their discretion in offshore funds.

(iv) Sales promotion to customers of institutions connected with the fund when these customers seek investment advice.

F. INFORMATION AVAILABLE TO INVESTORS

1. The Quality of Offshore Fund Prospectuses

a. Introduction

The Study reviewed the prospectuses of 20 offshore funds and compared the disclosure of these prospectuses with what would be required in the prospectus of an investment company registered with the Commission. In analyzing such a comparison, however, it must be remembered that the offshore fund prospectuses examined may reflect the standard practices or norms for fund sales operations in the countries where the shares are sold. Offshore funds that issue prospectuses are under no compulsion to meet Commission standards. Moreover, some countries do not require prospectuses at all. In those countries the regulations and prospectus type material governing the fund may be printed on the back of the share certificate itself.

b. An overall view

The analysis examines 20 offshore fund prospectuses issued by affiates of regulated United States financial institutions, United States hedge fund operators and foreign institutions to compare the disclosure contained in them against the disclosure that would be required of registered investment companies by the Investment Company Act and the Securities Act. Consideration was also given to the question of whether the type of disclosure made was significantly different among the groups which sponsor offshore funds.

One important requirement of the Investment Company Act is that registered investment companies must disclose their investment policies in order to afford an investor a basis on which to evaluate a company in relation to his objectives. In addition, that Act requires that certain of these policies cannot be changed without a vote of shareholders. Only two of the offshore fund prospectuses analyzed, both issued by affiliates of regulated U.S. financial institutions, made mention of any policies which required a shareholder vote for change.

The policies which must be disclosed in the prospectuses of investment companies registered with the Commission relate to:

(1) the issuance of senior securities,

(2) the borrowing of money,

(3) the underwriting of securities,

(4) the concentration of investments in particular industries,

(5) the purchase and sale of real estate,

(6) the purchase and sale of commodities and commodity contracts,

(7) the making of loans,

(8) the types of securities in which the company will invest,

(9) the percentage of assets which the company may invest in the securities of any one issuer,

(10) the percentage of voting securities of any one issuer which the company may acquire,
(11) investing for control of another company,
(12) investing in other investment companies, and
(13) the policy in respect to turning over the company's portfolio securities.

Generally missing from the offshore fund prospectuses studied were policies 1, 3, 7 and 13. Generally included in the prospectuses were policies 2 and 8. As for the other policies, 4, 5, 6 and 11 could usually be found only in prospectuses issued by affiliates of regulated U.S. financial institutions, while policies 9, 10, and 12 could usually be found only in prospectuses issued by that group and by foreign institutions. The prospectuses issued by U.S. hedge fund operators usually disclosed few, if any, policies.

It should be noted that where companies disclosed policies in their prospectuses, many of these policies would not meet the standards of clarity and completeness that would be required from a registered investment company.

Other information which is deemed essential for an informed evaluation of the securities offered is required to be disclosed in the prospectuses of registered investment companies. One primary requirement is the inclusion of audited financial statements, including a list of portfolio securities, in the prospectuses of registered companies. Only one company in each of the groups studied had any kind of financial statements.

Also generally omitted from the prospectuses was any disclosure concerning the method of allocating portfolio brokerage and the rights of the shareholders, such as voting rights. Other important areas including management fees and expenses, tax implications, redemption rights and the identification of management and other affiliated persons of the companies were generally mentioned in the prospectuses, but such disclosures varied widely among the companies as to the completeness and clarity of the statements made. There appeared to be no significant variation between the groups of companies as to the quality of such disclosures.

While most of the prospectuses examined contained little or no sales material, one prospectus issued by a foreign institution almost entirely consisted of sales related material, much of which appeared to be distorted and possibly misleading.

The areas considered above are those which would be discussed in the prospectuses of every registered investment company. In addition, other items such as material litigation and violations of law would be required to be disclosed where applicable. It could not be determined whether the companies reviewed were involved in such other matters, but it was noted that none of the prospectuses contained any disclosure of this type.'

c. Specific groups of funds

The prospectuses were initially divided into three groups: (1) those issued by affiliates of or funds connected with regulated U.S. financial institutions; (2) those issued by the operators of domestic hedge funds; and (3) those issued by foreign institutions. The Study examined significant items which a registered investment company would generally

be required to discuss in its prospectus and evaluated the disclosures which the offshore funds' prospectuses made in regard to these items.

(1) *Group one—affiliated or connected with regulated U.S. financial institutions.*—There were eight prospectuses in the first group. While not uniformly so, these prospectuses were, generally speaking, superior to the other two groups. They were basically more detailed than the second group and contained less of the objectionable flagrant puffing and sales literature often appearing in group three.

Although none of the prospectuses in group one reached the level required of a registered investment company, several could readily be brought to such a level by some additional sections.[12]

Generally speaking, none of the prospectuses examined in any of the groups developed or elaborated upon any possibly negative features of the particular offering, although the prospectus of one fund in group two compared its management fee to the more favorable management fee charged by the adviser to its domestic clients.

The closest any prospectus in group one came to any discussion of a possibly negative feature of the offering was a paragraph in one prospectus pointing out that there may be instances in which certain securities would be desirable for the fund's portfolio and in keeping with its investment policies, but the adviser might be forced to allocate these securities among the various entities to which it gives investment advice on a proportionate or even a rotating basis.

Although five of the funds in group one have positive incentive fee arrangements, not one mentions the lack of any corresponding downward adjustments.

Similarly, although a number of funds in group one accept requests for redemption only on a weekly or monthly basis, and several have various other limitations upon redemption rights (such as the requirement in the Netherlands Antilles that a fund may not redeem shares where such redemption would result in less than 20 percent of the authorized capital of the fund remaining outstanding), not one prospectus discusses or even mentions any possible resulting disadvantages to shareholders.

The prospectuses in group one were generally more complete in their discussion of investment policies than the prospectuses of funds in other groups, although there was wide variance within this group itself. The prospectus of one fund, for example, lists only three investment restrictions (the fund cannot purchase real estate, invest in other mutual funds or invest for purposes of exercising control). Another prospectus likewise lists only a handful of restrictions in its discussion of investment policy and restrictions.

Five of the funds utilize prospectuses which are detailed in their discussions of policies and restrictions. However, only one fund has any discussion of restricted securities (the fund's purchases of such shares cannot exceed 15 percent of its assets at the time of investment), and the prospectus does not discuss any of the possible negative results of such purchases.

Only the prospectuses of two of the funds make any mention of restrictions relating to the purchases of shares of affiliated companies.

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[12] No attempt was made to evaluate or compare the various practices engaged in. All comparisons made are limited to an evalution of the adequacy of the disclosures of such practices.

One prospectus states that "The Fund may not purchase shares of, or grant loans to (the affiliated company)." The other prospectus is the only one in the group which places restrictions on the purchasing or selling of portfolio securities to any officers or directors of the Fund and the adviser or firms of which any of them are members. In addition, the prospectus also prohibits the retention of any portfolio security when affiliated persons have a 5 percent interest in the issuer.

The majority of the prospectuses in this group included a discussion of policies pertaining to the borrowing of money, investing in real estate and commodities, the concentration and diversification of investments, the types of securities in which they would invest, investments in other investment companies and investing for purposes of exercising control. Only one prospectus includes any discussion of portfolio turnover policy. It denies any intention to trade for short-term profits, yet predicts a portfolio turnover rate "more extensive than those of other investment companies with different objectives."

Only three prospectuses in this group discuss the allocation of portfolio brokerage, a subject of quite considerable importance, but one which is omitted entirely in the prospectuses of the other two groups.

One prospectus simply states that the investment manager has "sole discretion in the choice of the brokers and dealers in the course of carrying out of purchases and sales of portfolio securities for the Fund."

Another prospectus lists five brokers through whom "substantially all portfolio transactions for the Fund will be made." Although the Fund did not commit itself to the pursuit of best price and execution, it did receive a promise from the enumerated brokers that they (the brokers) would seek best price and execution on behalf of the Fund.

The third prospectus contains the best discussion of this subject, committing the adviser to the obtaining of best price and execution for all portfolio transactions and discussing the allocation of brokerage to those responsible for sales and services to the Fund or its adviser.

In areas outside of investment policies, such as discussions of tax status, management fees and redemption rights, there appeared to be no general patterns distinguishing the various groups although it would be fair to say that, on average, the prospectuses in group one were a little more thorough than the other groups.

Within the group, there was again wide diversity. One prospectus, for example, is very brief in its discussion of tax consequences, concluding after a short paragraph that "Shareholders should inform themselves as to any other consequences which might be applicable to their ownership or sale of shares." Given the diverse international markets in which the Fund may offer its shares, perhaps this is a fair way of approaching the problem. However, another prospectus contains a full page on tax status which apparently treats the subject in a more thorough fashion.

The prospectuses in group one generally contain good sections dealing with advisers to the funds, again varying from a thorough descriptive section of the organization and personnel in one prospectus to surprisingly limited sections in the prospectuses of two others.

(2) *Group two—hedge funds.*—An examination of the prospectuses of four offshore funds sponsored by operators of domestic unregis-

tered "hedge funds," indicated that these prospectuses do not provide much meaningful information which would aid an investor in his investment decisions.[13]

The four prospectuses in this category almost completely omitted any discussion of investment policies. The prospectus of one states simply that it "has wide latitude" in the investments it may make and may "buy and sell securities without limitation as to type or industry concentration, sell securities short and cover such transactions, trade in puts and calls, borrow money and purchase securities on margin, all without limitation." Although this discussion of investment restrictions conveys very little of a concrete nature to the investor, it is more explicit than any of the others.

Another prospectus in this group states: "To get leverage the fund borrows monies and operates through margin accounts. Its borrowings are substantial in relation to its assets. Also it endeavors by short sales to hedge the risk of declines in the market." There is no mention of any policy or intention in regard to other fundamental matters.[14]

The prospectus of another offshore hedge fund defines hedging and short sales but also gives no indication of the boundaries within which the fund will be operated. A reader of the prospectus of one such fund is simply told that the fund will "acquire, hold and dispose of securities of all kinds." There is no further elaboration.

The prospectuses in this group deal primarily with the capital structure, sales and redemption of shares and the tax status of the funds. The sections on capital structure are the most elaborate in the four prospectuses; these sections also entail a discussion of the management fees since 20 percent of the increase in net worth is generally allocated to the class of stock held by the organizers of the fund.

The prospectus of one fund presents the material in most comprehensible fashion and calls the reader's attention to differences between the usual compensation scheme in domestic hedge funds and the prevailing scheme in the offshore fund run by the same operators. The prospectus states:

> It should be noted that in (X Company) and in (X Company Associates) (domestic private hedge funds) 20 percent of realized capital gains are allocated to the general partners. In the case of the Fund 20 percent of the net increase in net worth each year, whether or not realized, is allocated to the Class A stock and Class B stocks."

The tax discussion also vary widely among the prospectuses from a five line paragraph in one prospectus to a fairly extensive discussion in another.

Each of the prospectuses contains a discussion of redemptions but none really presents full disclosure to the investor since the limits upon redemptions required by the laws of the Netherlands Antilles (generally a requirement that 20 percent of the authorized stock remain outstanding at all times) are not fully developed, and one prospectus omits entirely any mention of this important restriction on the right to redeem.

The prospectuses in group two, therefore, fall far short of the standards required of registered investment companies.

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[13] These funds do not issue prospectuses in the U.S. because they are not publicly offered.
[14] See the list of 13 topics discussed in section F.1.b above.

(3) *Group three—foreign institutions.*—The prospectuses in group three vary more widely among themselves than do those in the previous two groups as to the quality and completeness of their disclosures.

The discussion of investment policies in group three generally were not as complete as in the prospectuses in group one. The sections in this group are basically limited to brief statements on the percentages of assets which can be invested in various types of securities.

One fund for example, will invest 55 percent of its assets in the U.S. and Canada, 30 percent in Europe, 10 percent in Japan and 5 percent in the Sterling area; another will invest 90 percent of its assets in listed or generally traded OTC shares; a third will invest 90 percent of its assets in an affiliated fund; a fourth will invest 75 percent of its assets in certain specified companies. One-half of the prospectuses in group three place a limit upon the percentages of assets which may be invested in the securities of any one issuer.

The prospectus of one fund states that "the Fund will diversify its portfolio among numerous industries and companies." However, it is difficult to judge the value of this limitation; a subsequent paragraph allows the Fund to "concentrate investments in securities of particular companies or within a particular industry or industries"; the terms "concentration" and "diversification" do not convey a precisely defined technical standard.

Three of the eight prospectuses in this group restrict the percentages of voting securities of any one issuer which the fund may acquire. Four prospectuses discuss investments in other investment companies—two specifically permitting and two prohibiting such purchases. Five prospectuses discuss the borrowing of money; one briefly mentions portfolio turnover policy; none discusses the allocation of portfolio brokerage.

The discussions of management fees were generally incomplete by the standards imposed upon registered investment companies, but several of the prospectuses in this group were about on a par in this area with the better discussions in groups one and two. Generally, they omitted mention of the possible inequities involved in allowing the adviser an incentive based upon a percentage of unrealized capital gains and failed to enumerate or limit the costs for which the management company could be reimbursed. One prospectus described an agreement to pay its trustee "an amount commensurate with work done"; another fund (which invests "primarily in hedge funds of recognized standing which invest in securities of United States companies") makes no mention of the payment of double management fees.

The prospectuses in group three generally contain more material of a sales or puffing nature than do those of the other two groups. This varies from the outrageously blatant to the quite subtle. The fact that a director is the relative of a former high government official adds nothing to his ability as a director, nor does the statement that a director has undertaken major governmental and diplomatic missions.

A registered investment company would not, of course, be permitted to enliven its prospectus with photographs of American rockets and computers or of Canadian and American oil and gas pipelines or with pages decorated with the corporate symbols of American industrial giants.

2. General Public Information

Aside from information in prospectuses, there is not readily available much public information on offshore mutual funds. Some prices are quoted daily in the Paris *International Herald Tribune* and the *Financial Times* of London.

The *Investment Companies International Yearbook* (four volumes), published in Rome by Antonio Ciaramella and Company, Financial Services S.r.l. contains summaries of prospectuses of some, but by no means all, offshore funds.

Fund Guide International, published monthly in Copenhagen provides price and performance data supplied by funds that pay a fee to *Fund Guide International.*

Seiden and De Cuevas International S.A., publish an *Offshore Fund Survey—Master Guide* but copies are reportedly difficult to obtain in the U.S.

A firm in London, Intervestment Management Limited, began to issue an *Analysis of Offshore Funds* in June 1970, including an index by name of fund with identification of management affiliation, assets, and relative performance ranking. Intervestment also promised to have available quarterly data on portfolio holdings.

Beyond this, there are occasional articles in magazines, but in general there is little published material to help the offshore fund investor evaluate the quality of his chosen or prospective investment vehicle.

G. REGULATORY AND TAX ENVIRONMENT

There is a three dimensional aspect to the regulatory and tax environment affecting an offshore mutual fund. This includes (1) U.S. considerations, (2) the provisions governing the fund in its legal domicile, and (3) the regulations in the countries where the fund shares are sold.

This chapter does not attempt to explore exhaustively all elements involved. In what follows, U.S. securities and taxation considerations are dealt with in detail. An outline is included of regulations and taxes in the offshore domiciles. Finally, there are brief comments on trends governing the sale of offshore fund shares in individual foreign markets.

1. Regulatory Aspects in the U.S.

a. Securities and Exchange Commission regulation

The effect of the Investment Company Act and the Securities Act on offshore funds was discussed in section A of this chapter. Other provisions of the federal securities laws must also be considered.

With minor exceptions, the Securities Exchange Act of 1934 prohibits any broker or dealer from using the jurisdictional means to effect any transaction in, or to induce the purchases or sale of any security, unless the broker or dealer is registered with the Commission.[15] The

[15] Section 15(a)(1) of the Securities Exchange Act, 15 U.S.C. § 78o(a)(1).

term "dealer" is defined in section 3(a) (5) of the Securities Exchange Act [16] to mean:

any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business.

A domestic investment company or an offshore fund could be viewed as being in the business of buying and selling securities (those they issue and those issued by portfolio companies) for its own account, although the Commission has not required any investment company to register as a broker or dealer. If investment companies were treated as "dealers," it could be argued in the case of offshore funds that section 30(b) of the Securities Exchange Act might prevent an offshore fund from being required to register as a broker-dealer. Section 30(b) provides that the Securities Exchange Act,

"shall not app'y to any person insofar as he transacts a business in securities without the jurisdiction of the U.S., unless he transacts such business in contravention of such ru es and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of [the Act]." [17]

In *Roth* v. *Fund of Funds, Ltd.*,[17a] a case involving the prohibition found in section 16(b) of the Securities Exchange Act against short swing transactions by insiders, the Court held that Section 30(b) did not apply to the Fund, which had its offices in Geneva, Switzerland. The Court said:

. . . when the Fund bought and sold the securities in question on the New York Stock Exchange, utilizing New York City stock brokers to execute its orders to buy and sell, and made payment for the purchases through a New York bank, it was not transacting a "business in securities without the jurisdiction of the United States."

There is also dicta in the opinion that the phrase "transacting a business in securities" might not cover a fund's activities of investing in securities.

The regulatory pattern of the Investment Advisers Act of 1940 has been set out in section A of chapter IV. In general, that Act prohibits any investment adviser from making use of the jurisdictional means in connection with his business, unless he is registered with the Commission.

If an investment adviser of an offshore fund is registered under the Investment Advisers Act, it becomes necessary to determine whether the performance fee restrictions of that Act apply to contracts with offshore funds. They do not apply to a contract with "an investment company" (Section 205), and managements of offshore funds have sometimes assumed that the exemption applies to unregistered offshore funds as well as registered investment companies. The staff of the Commission has taken the position that only contracts with registered investment companies are exempt.[18] The Investment Company Amendments Act of 1970 clarifies this point by permitting such arrangements only with respect to companies registered under the Investment

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[16] 15 U.S.C. § 78c(a) (5).
[17] No rules have been adopted pursuant to this section.
[17a] 405 F. 2d 421 (C.A. 2, 1968), *cert. denied*, 394 U.S. 975 (1969).
[18] Hearings Before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737, 91st Cong., 1st Sess., Pt. 1, at 206 (1969).

Company Act and any other person, except pension and profit sharing plans, having at least $1 million under management with the adviser.[18a] The Amendments Act also limits such fees so that they must increase and decrease proportionally in relation to an index of securities prices or other appropriate measure. See section F of chapter IV concerning performance fees generally.

b. Other federal regulatory aspects

Neither the Comptroller of the Currency nor the Board of Governors of the Federal Reserve System has adopted regulations directed at bank-affiliated offshore funds, although investment in offshore mutual funds by U.S. financial institutions is subject to the guidelines of the voluntary foreign credit restraint (VFCR) program administered by the Federal Reserve. These guidelines differentiate to some extent among lenders, geographic areas, and maturities, but do not differentiate among obligors. Thus, an investment in an offshore mutual fund is treated like an investment in any other foreign entity.

In order to accommodate differences in lending and investing activities, one set of guidelines applies to banks, that is, commercial banks (except their trust departments), bank holding companies, "Edge Act" and "Agreement" Corporations, and a second set applies to nonbank financial institutions, for example, insurance companies, investment companies, pension funds, bank trust departments.

Restraints under both sets of guidelines are in terms of an overall ceiling on outstanding claims, based on total holdings as of a specified past date. Within each institution's overall ceiling, special and more stringent restraints are imposed on total claims against obligors in the developed countries of continental Western Europe, and on holdings of liquid assets abroad.

The VFCR guidelines, which impose no restraints for nonbank financial institutions and for domestic subsidiaries of Edge Act and Agreement Corporations, otherwise cover assets to the extent that funds have been raised by the institution through long-term borrowing abroad. For nonbank institutions, long-term investments (direct investments, credits with final maturities of more than 10 years, equity securities) in the developing countries are also not subject to the guideline restraint so long as such investments are not inconsistent with other aspects of the Government's balance of payments program.

Investments in offshore funds by corporations and private U.S. residents could be subject to provisions of the Commerce Department's Foreign Direct Investment Program (FDIP).

One lower court has held that the Federal Reserve System's margin requirements do not apply to loans by non-resident foreign lenders to domestic borrowers.[18b] However, this view is not necessarily shared by regulatory authorities.[19] Many of the offshore funds questioned stated that their investment policy includes leverage techniques. (The Study is not aware of any significant margin requirements outside the U.S.)

[18a] Effective December 14, 1971.

[18b] *Metro-Goldwyn-Mayer, Inc.* v. *Transamerica Corp.*, 303 F. Supp. 1354 (S.D.N.Y., 1969).

[19] These differences appear to have been largely mooted by the provisions of Pub. Law No. 91-508 (Oct. 26, 1970) which in substance prohibits a "United States person," as there defined, from obtaining or receiving credit from any lender to purchase or carry United States securities or other securities within the United States if the loan would be prohibited if made within the United States.

c. New York Stock Exchange rules

In addition to the restrictions on member firms' receipt of performance fees the NYSE rules affect offshore funds by restricting the business connections of member firms and certain of their partners and shareholders. The Exchange's Rule 318 provides that such firms and persons may not become associated with any "outside" businesses without the prior approval of the Exchange. In effect, Rule 318 provides that a member organization may have a wholly-owned subsidiary but must get Exchange approval before acquiring a partial interest in an entity.

The Exchange has permitted member firms to have some partial foreign interest, but not interests in brokerage firms. Member firms are permitted to engage abroad in advisory or underwriting activities in conjunction with either member or non-member firms. In each such case, the Exchange's approval must be obtained, and the member must certify that all such activities will take place abroad.

2. U.S. Tax Environment

Both U.S. and foreign taxes have an impact on the foreign investor in an offshore fund, and on the management of an offshore fund, including U.S. shareholders in the management.

One primary consideration is that an offshore fund can be exempt from the U.S. capital gains tax if its principal office is outside the U.S. This permits the portfolio of an offshore fund to be managed more aggressively, without considerations related to holding the securities a given number of days. In addition, interest and dividends are subject to U.S. withholding taxes at the rate of 30 percent where not reduced by treaty.

It can be argued that U.S. tax law, which imposes an estate tax on foreign persons (albeit at considerably reduced rates since passage of the Foreign Investors Tax Act of 1966), provides an incentive for an individual foreign investor to invest in the U.S. through an offshore fund established in a country with no estate tax (or through a foreign bank with the purchase order made in the bank's name). The offshore fund purchases and manages the U.S. securities in its own name. Should the foreign shareholder die, he avoids U.S. estate tax and probate. Thus, there may be a built-in bias against dealing directly with a U.S. broker or mutual fund.

There were offshore funds operating successfully before the Foreign Investors Tax Act was enacted. These included some domiciled in the Carribean, affiliated with U.S. banks and mutual fund management companies. It also included the Fund of Funds.

A fillip was provided by the Foreign Investor Tax Act by permitting a foreign investor to grant discretionary authority to a U.S. agent without subjecting the investor to graduated U.S. income and capital gains tax, as had previously been the case. This gave U.S. investment advisers considerably more flexibility in their association with offshore funds (or vice versa).

Frequently offshore funds are organized by U.S. interests who may want an equity participation. There are some U.S. tax advantages for these persons, including relatively low taxation of the offshore fund in the U.S. and in the country of domicile, and possible deferral

of the U.S. shareholder's gain in the equity until his shares in the fund are sold. Certain difficulties can be raised for the fund and its U.S. shareholders unless care is taken to avoid Internal Revenue Code provisions governing foreign personal holding companies, the accumulated earnings tax, controlled foreign corporations, and foreign investment companies.

The above considerations are examined in the sections that follow. Two other related areas will be cited here, but not explored further. These are possible payment of the U.S. interest equalization tax (IET) if the shares acquired by the U.S. investor do not constitute a direct investment (that is, at least 10 percent of the voting power of the corporation's stock) and possible application of the Commerce Department Foreign Direct Investment Program (FDIP) regulations. The FDIP regulations might provide for repatriation requirements that could raise possible income tax problems.

The existence of a favorable double taxation treaty between the U.S. and the country of domicile can be important, as can the tax rules in the country of domicile of the offshore fund. Some of these are also outlined below.

a. The Foreign Investors Tax Act of 1966

(1) *General scope of the Act.*—The Foreign Investors Tax Act of 1966 (FITA) completely restructured the U.S. tax provisions governing nonresident alien individuals and foreign corporations. The two-fold purpose of the FITA was to provide more equitable tax treatment of such foreign taxpayers and to stimulate foreign investment in the U.S. To obtain such objectives, the FITA spanned the basic income, estate and gift tax provisions dealing with foreign taxpayers.

The origins of the FITA are contained in the Report of a special task force (Fowler Report)[20] appointed by President Kennedy, charged in part with developing programs for "a broad and intensive effort by the U.S. financial community to market securities of U.S. private companies to foreign investors" and "a review of U.S. Government and private activities which adversely affect foreign purchases of the securities of U.S. private companies." Many of the specific recommendations in the Report were enacted in the FITA.

A summary comparing the provisions of the old tax law and the FITA (new tax law) is found in appendix J.

(2) *Effectively connected income*

The most fundamental structural and conceptual innovation introduced by the FITA was the concept of "effectively connected" income. Generally, for taxable years after 1966, all income of nonresident alien individuals and foreign corporations which is effectively connected with the conduct of a trade or business within the United States is taxed at the same rates which apply to United States citizens and domestic corporations. On the other hand, all U.S. sourced gross income of such foreign taxpayers from "fixed or determinable annual or periodical income" (interest, dividends, rent, wages, etc.) is taxed at a flat 30 percent rate (or lower treaty rate) whether or not the recipient

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[20] *Report to the President of the United States from the Task Force on Promoting Increased Foreign Investment in United States Securities and Increased Foreign Financing for United States Corporations Operating Abroad,* Government Printing Office, 1964.

engages in a trade or business in the U.S., so long as such income is *not* effectively connected with the conduct of a trade or business within the U.S.

(3) *Trading in stock, securities and commodities.*—With respect to the question of what constitutes a "trade or business within the U.S.," the FITA made several substantive changes in the rules applying to foreign taxpayers conducting trading activities in stocks, securities, and commodities in the U.S. These changes are incorporated in section 864(b)(2) of the Internal Revenue Code which provides rules for determining whether and under what conditions such trading constitutes engaging in trade or business within the U.S.

The relevant statutory rules applicable to offshore funds and foreign investment companies are contained in section 864(b)(2)(A)(ii) of the Code. That section provides the general rule that the term "trade or business within the U.S." *does not include* "trading in stock or securities for the taxpayer's own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian or other agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions."

However, the second sentence of section 864(b)(2)(A)(ii) provides that the above stated general rule "shall not apply in the case of a dealer in stocks or securities, or in the case of a corporation (other than a corporation which is, or but for section 542(c)(7) or 543(b)(1)(C) would be, a personal holding company) the principal business of which is trading in stocks or securities for its own account, if its principal office is in the U.S."

In summary: (a) *The offshore fund would want very much to benefit from the exemption* in the FITA and would not maintain a principay office in the U.S. The broad exemption from U.S. trade or business of the Code does not apply to dealers or to a foreign investment company which maintains its principal office in the U.S. (b) The statutory "principal office" limitation on the general exemption provided by section 864(b)(2)(A)(ii) does not apply to corporations which are essentially personal holding companies under U.S. tax law. Thus, a foreign investment company which is, or but for section 542(c)(7) or section 543(b)(1)(C) would be, a personal holding company, can maintain its principal office in the U.S. without being considered as being engaged in trade or business within the U.S., for U.S. tax purposes. However, the offshore fund would want to avoid being placed in this category because unless it qualified for the exceptions to personal holding company status provided in section 542(c)(7) or section 543(b)(1)(C) it would be subject to a personal holding company tax equal to 70 percent of its undistributed personal holding company income.

(4) *The principal office test.*—The most difficult technical questions raised by section 864(b)(A)(ii) and the regulations thereunder relate to the question of whether the principal office of a foreign investment company or an offshore fund is in the U.S.

Section 1.864–2(c)(2)(iii) of the regulations provides that whether a foreign corporation's principal office is in the U.S. is to be determined by comparing the activities (other than trading in stock or securities) which the corporation conducts from its office or other fixed place of business located in the U.S. with the activities it conducts

from its offices or other fixed places of business located outside the U.S.

Moreover, for purposes of section 1.864–2(c)(2)(iii) of the regulations, a foreign corporation is considered to have only one principal office, and an office of such corporation will not be considered to be a principal office merely because it is a statutory office of such corporation.

The "principal office" concept is illustrated in the regulations by the example of a foreign corporation which carries on most or all of its investment activities in the U.S. but maintains a general business office outside the U.S. in which its management is located and at which all or a substantial portion of the following management functions are carried on:

(1) Communicating with its shareholders,

(2) Communicating with the general public,

(3) Soliciting sales of its own stock,

(4) Accepting the subscriptions of new shareholders,

(5) Maintaining its principal corporate records and books of account,

(6) Auditing its books of account,

(7) Disbursing payment of dividends, legal fees, accounting fees, and officers and directors' salaries,

(8) Publishing or furnishing the offering and redemption prices of shares of stock issued by it,

(9) Conducting meetings of its shareholders and board of directors, and

(10) Making redemptions of its own stock.

Examples (1) and (2) of section 1.864-2(c)(2)(iii) of the Internal Revenue Service regulations further illustrate the application of the "principal office" concept. Example (1) involves foreign corporation X, which for a period of three years, irrevocably authorizes domestic corporation Y to exercise its discretion in trading in stock and securities for the account of X pursuant to an investment advisory contract. In concluding that the principal office of foreign corporation X would not be considered to be in the U.S., the example emphasized the following facts:

(1) Y's activities consisted primarily of rendering investment advice and effecting stock and securities transactions in the U.S. for the account of X.

(2) Shares of X were sold to nonresident aliens and foreign corporations who were customers of U.S. brokerage firms unrelated to Y or X.

(3) Y's management occasionally communicated with prospective foreign investors in X through foreign speaking engagements for the purpose of explaining the investment techniques and policies used by Y in investing the funds of X.

(4) X maintained a general office or offices outside the U.S. in which its management was permanently located and from which was carried on, except to the extent indicated in (1) and (3), the management functions enumerated in (1) through (10) of regulation section 1.864–2(c)(2)(iii).

(5) The management of X at all times retained the independent power to cancel the investment advisory contract with Y and was in all other respects independent of the management of Y.

In example (2) of section 1.864-2(c)(2)(iii) of the regulations, the facts are the same as in example (1) except that instead of having the investment advisory contract with Y, X had an office in the U.S. in which its employees performed the same functions as were performed by Y in example (1). The example concludes that X was not engaged in a trade or business within the U.S. during the taxable year solely because the employees in its U.S. office effect transactions in the U.S. in stock and securities for the account of that corporation.

As an example of the application of the foregoing described principles, when the only significant U.S. activities conducted by or for an offshore fund (other than commercial banking functions performed by U.S. banks) consist of purchase and sale transactions, investment advice, and valuation of investment portfolios, the offshore fund would not be considered as engaged in trade or business within the U.S. by virtue of such activities.

These activities may be performed on behalf of the offshore fund by an unrelated U.S. investment adviser with no discretionary authority to buy and sell on behalf of the fund or by a resident agent of the fund with discretionary authority as to purchase and sale.

Despite the examples given by the Internal Revenue Service regulations, there appears to be some uncertainty on the part of the financial community as to the precise meaning of "all or a substantial portion" of the ten management functions listed above (frequently referred to as "the ten commandments"). Can an offshore fund perform one or two of them entirely in the U.S., or may a small part of each of the 10 be performed in the U.S.?

This uncertainty has led some law firms to counsel their clients to completely avoid insofar as possible performing any of these functions in the U.S., and this apparently has some disadvantages.

Investment advisers, accountants, and lawyers who work with offshore funds have indicated that it would be useful to them for administrative purposes to be able to maintain principal corporate records and books of account in the U.S., and to have the audit of the books of account in the U.S. rather than overseas. They do not do so at present for fear of an adverse ruling that the offshore fund's principal office is in the U.S.

In the event that the principal office of an offshore fund is determined to be in the United States, such fund will, as noted above, be considered as engaging in a trade or business within the United States under section 864(b)(2)(A)(ii) of the Internal Revenue Code. The determination that an offshore fund or a foreign investment company is engaged in trade or business within the United States would trigger United States taxation of both its United States and foreign source income.

The consequence of this determination is prescribed in section 864(c)(1)(A), which provides in part that in the case of a foreign corporation engaged in trade or business within the United States the rules set out in sections (2), (3) and (4) of section 864(c) shall apply in determining the income, gain or loss which shall be treated as effectively connected with the conduct of a trade or business within the United States.

Section 864(c)(2) provides, in effect and in part, that in determining whether United States sourced income of the types described in section 871(a)(1) or section 881(a), or whether gain or loss from sources within the United States from the sale or exchange of capital assets, is effectively connected with the conduct of a trade or business within the United States, the factors taken into account shall include whether (a) the income, gain, or loss is derived from assets used in or held for use in the trade or business, or (b) the activities of such trade or business were a material factor in the realization of the income, gain or loss.

With respect to foreign source income, section 864(c)(4) provides, in part, that income, gain or loss from sources without the United States received by a foreign corporation shall be treated as effectively connected with the conduct of a trade or business within the United States if such corporation has an office or other fixed place of business within the United States to which such income, gain or loss is attributable and such income, gain or loss consists of dividends or interest, or gain or loss from the sale or exchange of stock or notes, bonds or other evidences of indebtedness and is received by a corporation the principal business of which is trading in stocks or securities for its own account.

(5) *Changes in estate tax rates effected by the FITA.*—Prior to the passage of the FITA, estate tax rates were the same for both United States citizens and nonresident aliens owning property situated in the United States. However, the estate of a nonresident alien was not accorded the benefits of the marital deduction (Internal Revenue Code section 2056). The estate was only allowed a $2,000 specific exemption instead of the $60,000 applicable in the case of U.S. citizens. (Code section 2052). It was felt that such undue discrimination in the estate tax treatment of aliens discouraged foreign investment and had a detrimental effect on this country's balance of payments.

The changes made by the FITA were designed to alleviate these difficulties. It established a separate schedule of estate tax rates, applicable only to the estate of nonresident aliens who die with property situated in the United States. The new rates attempt to equalize the tax imposed on the estate of a nonresident alien who does not receive the benefit of the marital deduction with the tax imposed on an estate of similar value of a United States citizen who is accorded the maximum marital deduction. The exemption was raised from $2,000 to $30,000 and considerably reduced rates were introduced on a graduated scale.[21]

For the purpose of this chapter, the point is that a nonresident alien who invests in U.S. securities through the medium of an offshore fund (or through a foreign financial institution with the order to purchase placed in the name of the foreign institution) avoids the reduced estate tax completely. This leads to an assumption that only the relatively small or unsophisticated foreign investor would purchase U.S. securities directly in his own name, at least in the absence of major contrary considerations.

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[21] If the taxable estate is not over $100,000, the tax shall be 5 percent of the taxable estate; over $100,000 but notover $500,000, the tax shall be $5,000, plus 10 percent of excess over $100,000; over $500,000 but not over $1,000,000, the tax shall be $45,000, plus 15 percent of excess over $500,000; over $1,000,000 but not over $2,000,000, the tax shall be $120,000, plus 20 percent of excess over $1,000,000; over $2,000,000, the tax shall be $32,000, plus 25 percent of excess over $2,000,000.

3. Tax Consequences to United States Shareholders in Offshore Funds

There are a few particular situations in which U.S. shareholders—that is, usually the funds' management—can be subjected to higher rates of U.S. income tax and at least one situation in which the offshore fund might be subjected to the accumulated earnings tax. These situations concern the percentage of U.S. ownership, voting power and value of the fund's stock. Problems, if they arise, usually come during the organizational stages, but in general they seem to be avoided without difficulty.

Details are treated below in summary fashion. A more complete technical discussion is found in appendix K.

(i) *Foreign personal holding company provisions* of the Code (sections 551–558) apply if at any time during the taxable year more than 50 percent of the *value* of the offshore fund's stock is owned, directly or indirectly, by or for not more than five individuals who are citizens or residents of the United States. The result is that the U.S. stockholders would have to include their share of the undistributed foreign personal holding company income of the fund in their own gross income for tax purposes.

(ii) *Controlled foreign corporation* provisions of the Code (sections 951–964) apply to U.S. shareholders who own or are considered to own 10 percent or more of the total combined *voting power* of a foreign corporation, the voting stock of which is owned more than 50 percent by such United States shareholders. Generally stated, the result is that these shareholders must include in their gross income their pro rata share of the fund's "subpart F income" plus certain other amounts specified in section 951 of the Code.

(iii) *Foreign repatriated earnings provisions* (section 1248) complement the controlled foreign corporation provisions, with respect to the sale or exchange of stock by U.S. owners of 10 percent or more of the combined voting power of a fund while it was a controlled foreign corporation. Earnings and profits attributable to the controlled foreign corporation are taxed at ordinary income tax rates.

(iv) *Foreign investment company* provisions (section 1246) apply when more than 50 percent of the total combined *voting power* of all classes of stock entitled to vote, or of the total *value* of shares of all classes of stock is held directly or indirectly by U.S. persons. The result would generally be to treat the gain on the stock as ordinary income rather than as capital gain.

(v) *Accumulated earnings tax* provisions (section 531) are applicable to offshore funds (and other companies) with respect to any income derived from sources within the United States if any of its shareholders are subject to income tax on the distribution of the corporation *by reason of being citizens or residents of the United States.* The aim of the accumulated earnings tax is to encourage distributions where the shareholders would otherwise benefit from the accumulation by the fund of non-taxed earnings and profits.

The accumulated earnings tax rates are 27.5 percent on accumulated taxable income not in excess of $100,000 and 38.5 percent of the accumulated taxable income above $100,000.

One means an offshore fund has to avoid this problem is to distribute dividends to the shareholders. This generally qualifies for a dividends

paid deduction, adjusting downward taxable income on which the tax applies. This adjustment to the tax requires that the offshore fund file a tax return.

(vi) *The two-tier company.*

Another solution used by many offshore funds to avoid the accumulated earnings tax is to set up as the subsidiary of another foreign company, basically a holding company. Usually there are two classes of stock, the offshore fund having class A (common) and B (preferred) shares. The holding company purchases or holds all the class A shares and these in turn are sold to foreigners.

The offshore fund can make distributions to its parent holding company for class A shareholders without subjecting them to the accumulated earnings tax because there are no U.S. shareholders in the parent company. The holding company can take into account the wishes of the foreign shareholders concerning distributions or reinvestment, independent of the need for the offshore fund to make distributions in its own right.

This arrangement permits the offshore fund operating company to be partially owned by U.S. citizens in proportions not exceeding the limitations set forth above for controlled foreign corporations, foreign personal holding companies, and foreign investment companies. The offshore fund operating company would distribute the year's income and gains on a pro rata basis. U.S. shareholders would be in the same position as if they were receiving the returns from a domestic hedge fund (that is, limited investment partnership) while foreign shareholders would be exempt from these U.S. tax considerations.[22]

4. Tax Status of Management Companies [23]

Because they are not regulated under United States' securities laws, the inter-relationships between the funds' management and advisers and sales representatives have permitted maximization of fees and profits. Typically, a fund would be established in a tax haven and the shares would be sold to persons outside the United States unrelated to the owners and officers of the management company or adviser.

A management company, controlled by the promoters, might be established offshore in another or the same tax haven to receive management fees from the fund. Since the fund was an unrelated person, the services would not generate *foreign base company service income* under Subpart F of the Internal Revenue Code, and, therefore, could be accumulated in the management company without current taxation of the U.S. owners.

Under section 1248 of the Code, however, the sale of shares in the management company or its liquidation would result in ordinary income rather than capital gain. Many promoters have contemplated the future issuance of additional shares to foreign investors to "de-control" the company and permit capital gain treatment for the U.S. persons at a later date. In some cases a separate foreign sales company has been established. Ordinarily, the sales company pays most of the com-

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[22] For further explanations of this technique, see A. Francke and W. Robertson, "Offshore Investment Funds," in *Investment Partnerships and "Offshore" Investment Funds*, Practicing Law Institute 266–267 and 286–289 (1969); and Haskins "Comment: The Off-Shore Hedge Fund" 8 Colum. J. Transnat'l L. 90–93 (1969.)

[23] This section and the following one draw on material supplied by Robert P. Patrick, Jr. Associate Tax Legislative Counsel (International), U.S. Treasury Department.

missions it receives to its salesmen and would accumulate relatively little income. The principal income accumulation would be in the management company.

Management fees and sales commissions are comparable to (or in some cases, higher) than fees charged initially by United States funds. As already noted, the United States promoters often organize an investment company in which they would own a percentage of the stock. The company would make annual distributions of income and capital gains to (a) a separate holding company owned by the foreign investors and (b) to the U.S. owners (either directly or possibly to an intermediary foreign holding company) to avoid a potential accumulated earnings tax problem if there is no distribution to the U.S. shareholders.

A substantial number of funds have been established offshore without the use of an offshore management company. In such case, investment advisory fees have been paid to domestic investment advisers who have ordinarily been instrumental in setting up the offshore fund. The U.S. tax issue of where a foreign fund has its principal office is magnified in these cases, although it is an issue as well in the case of funds managed by offshore management companies.

In addition, in the case of an offshore management company, there is an issue as to the taxability of the income of the management company, as well as the income of the fund. If the fund is not a related person, service fees paid the management company are not taxed constructively to the U.S. owners of the management company. On the other hand, the management company, unlike the fund, has no special rule protecting it against U.S. taxation where it has some U.S. business activity. The management company is taxable by the U.S. if it engages in trade or business in the U.S. through a permanent establishment.

Since U.S. owned offshore management companies are frequently related to U.S. investment advisers who supply them with investment advice (if not decisions), there is always a potential issue as to whether the U.S. advisers are a permanent establishment of the foreign management company.

The substance of the management company and the degree of independence are factors that would determine whether it is (1) a sham that can be disregarded, (2) so closely managed by the related U.S. advisers as to have a U.S. establishment, or (3) a sufficiently independent entity not engaged in trade or business in the U.S. In addition, where advice is received from a related person, the compensation arrangements must be such that the U.S. entity is sufficiently compensated to meet the arm's length requirements of Code section 482.

Certain offshore funds have organized investment programs along the lines of domestic mutual fund investment programs whereby subscribers indicate their intention to subscribe to a specified amount of fund shares over a given period of time. The investment programs would be organized as foreign corporations or foreign trusts and these corporations or trusts would purchase shares in the offshore fund that had been created by the promoters. The investment programs have permitted ease of transfer of share interests and probably facilitated the avoidance of local taxes in the countries of residence of the foreign investors.

5. Regulation and Taxation in the Country of Domicile [24]

A second dimension of regulation facing an investment adviser or management company establishing an offshore fund relates to the country of legal domicile of the fund—where is it incorporated, and why? For example, depending upon the aims of the fund's organizers, national regulations governing the following areas would need to be considered:

(i) must securities be registered; can they be issued in bearer form?

(ii) does the country of incorporation permit variable capital (that is, open-end) funds, require fixed capital, or permit both?

(iii) what are the listing requirements if the fund plans to list in the country of domicile; will the fund shares be acceptable for listing elsewhere; can bearer depository receipts ("BDR's") be issued if necessary to provide anonymity?

(iv) are there nationality requirements for directors?

(v) what is the permitted language (or languages) for incorporation, charter, use of the fund name, and sales literature?

(vi) what are the restrictions, if any, on the currency in which fund assets can be denominated?

(vii) are there differences in the rights and issuance of different classes of stock, and on their transfer?

(viii) what are the custodial or bank depository requirements?

(ix) is there an advantageous tax treaty with the U.S.?

(x) what are the local income, capital gains, estate, transfer and capital incorporation taxes?

(xi) can some difficulties be minimized by incorporating the fund in one country, say for tax purposes, and establishing the management company in another for greater ease in communications and language?

(xii) what are the required accounting standards; what information, if any, need be made available to shareholders?

(xiii) what rights (if any) do shareholders have over election of and representation on the management and on the board of directors?

(xiv) what is the quality and reputation of the local professional staff?

(xv) what is the local political and legal climate; how stable is the Government?

(xvi) how much freedom is there from local government interference?

The above list is not exhaustive, but gives an idea of some of the elements a nascent offshore fund's management would probably discuss with its lawyers and accountants.

a. Some specific examples [25]

This section summarizes the factors involved in the choice of location for an offshore fund or management company and a discussion of the tax aspects of certain funds.

In the jurisdictions employed as the domicile for a fund or investment program, there are usually minimal local taxes, relative freedom from exchange controls and the use of bearer shares. Since many of the

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[24] This section draws on the edited transcript of a discussion on "Offshore Investment Funds" by A. Francke, III and W. Robertson III, *Investment Partnerships and "Offshore" Investment Funds*, Practicing Law Institute 242–290 (1969).

[25] This section draws on the memorandum from R. Patrick, above n. 23 and Francke-Robertson discussion, above n. 24.

funds depend upon asset appreciation or capital gains, the U.S. withholding tax of 30 percent may not be a particularly important factor, although efforts are made to obtain a reduced rate in the few instances in which this remains possible.

Respectability, while subjective and a matter of degree, is a major intangible factor that strongly influences the choice. The Netherlands Antilles has generally been regarded as respectable and attractive to Europeans. Undoubtedly, Canada, Switzerland and Luxembourg are as respectable, but the tax cost is greater. Bermuda and the Bahamas have been regarded favorably but the Study has been told that the image of the Bahamas has declined in recent years. Panama, Liberia and Liechtenstein are reportedly less favorably regarded locations, and tend to be used more often as the situs of a management or sales company than for a fund. Frequently, management companies may be incorporated in one tax haven and have their operating office in a jurisdiction that offers low tax rates or other incentives to headquarters companies, such as in the U.K., Belgium or Switzerland.

A highly significant factor in choosing the situs of a management company, or its offices, is the availability of banking and other facilities for the back office work of the fund. The fund's portfolio and cash is uniformally in the hands of one or more bank custodians and payments by investors for purchases of fund shares and the issuance of shares are usually effected through bank facilities outside the United States.

Jurisdictions that have been employed as the situs for offshore mutual funds and management companies include:

(a) the Bahamas,
(b) Bermuda,
(c) Canada,
(d) the Cayman Islands,
(e) the Channel Islands,
(f) Liechtenstein,
(g) Liberia,
(h) Luxembourg,
(i) The Netherlands Antilles,
(j) Panama, and
(k) Switzerland.

(1) *The Bahamas.*—A limitation on the use of the Bahamas as the situs for a mutual fund is that the Bahamas is within the Scheduled Territories (that is, the Sterling Area) and subject to British exchange control regulations. Technically, the local authorities have considerable autonomy but agree to cooperate with the U.K. authorities. A mutual fund must obtain "non-resident" status from the authorities in the Bahamas, which would require that shares of the fund not be sold to residents of the Scheduled Territories.

There are no income or estate taxes in the Bahamas. No withholding tax is imposed upon capital gains of a Bahamian fund. There is no income tax treaty between the United States and the Bahamas. Therefore, U.S. dividends and interest are subject to a 30 percent United States withholding tax.

Incorporation is a relatively simple matter and it is now possible to issue bearer shares (subject to special exchange control restrictions). A frequent practice in the Bahamas is to incorporate a management

company and to establish a trust to serve as the vehicle for the fund. There are limitations on the redemption of ordinary shares of a corporation and this presents a problem for the use of a corporate form for an open-end fund. Recent administrative action in the Bahamas has required that management companies and funds obtain prior government approvals under the local trust company laws.
However, since the trust concept is recognized in the Bahamas, trusts for investment programs have been created there with some frequency.

New legislation affecting mutual funds has reportedly been drafted. Concern has been expressed in the past two years concerning the intentions of the government of the Bahamas with respect to increased government regulation of financial institutions and mutual funds. This apprehension has been a deterrent to the plans of some promoters to establish Bahamian funds. It has been somewhat less of a deterrent to the establishment of management companies. The Bahamas provides the services of a number of well-known banking institutions and their affiliates.

(2) *Bermuda.*—Bermuda is similarly within the Scheduled Territories and subject to limitations on the sale of shares to Sterling Area residents. Incorporation of a mutual fund or management company is subject to delay since each corporation is established through an act of the local legislature. While time consuming, this permits the company articles to differ from the various standard company laws. The fund's articles give it license to do what its specific act of incorporation permits it to. Bearer shares are permitted in limited circumstances. Redemption of preference shares is permitted, but at least $12,000 in common shares must remain outstanding. There are no income or estate taxes in Bermuda and there is no withholding on distributions by Bermuda corporations and trusts. There is no tax treaty between the United States and Bermuda. The political climate is reportedly regarded as having greater stability than is found in the Bahamas.

(3) *Canada.*—Prior to 1965, it was possible to incorporate a company in Canada and avoid any Canadian income or estate taxes by having the corporation conduct all of its business outside of Canada and be managed by persons who were not residents of Canada and who conducted their management activities outside of Canada. The Canadian tax status of such companies continues to depend upon maintaining such nonresident character.

The Fund of Funds and other mutual funds were established in Canada under the then existing Canadian law and have continued to operate without being subject to Canadian taxes. Investors Overseas Services' ("I.O.S.") real estate fund is also a nonresident company, apparently incorporated prior to 1965, although its shares were not offered prior to 1968. The Canadian nonresident funds were incorporated in low tax provinces to avoid significant local taxes. In 1965 Canada provided that any corporation incorporated thereafter in Canada would be a resident corporation subject to Canadian Federal income tax.

In addition to the foregoing NonResident Owned Corporations, mutual funds have also been incorporated in Canada as NonResident Owned Investment Companies. Under Canadian law, such companies,

which are "resident" for Canadian income tax purposes, are subject to a 15 percent tax on their investment income in the form of dividends and interest. There is presently no Canadian capital gains tax on securities transactions. There is no withholding tax on distributions by a Canadian NonResident Owned Investment Company.

The original purpose of this law was to permit nonresidents to hold their Canadian portfolios in corporate form without subjecting the shareholders to Canadian taxes greater than the 15 percent tax that would be due on a dividend paid by a Canadian corporation in which the foreign owner invested directly. However, the law does not require that investments be in Canadian securities and a NonResident Owned Investment Company may have a portfolio consisting entirely of United States securities.

Under the tax treaty between the United States and Canada, dividends and interest paid to a corporation that is resident in Canada are subject to a 15 percent withholding tax. The 15 percent Canadian tax imposed upon dividends received by a NonResident Owned Investment Company is imposed after deduction of the 15 percent U.S. withholding tax and certain operating expenses. The effect is to produce an aggregate tax rate on a dividend from a United States company that is less than the 30 percent U.S. withholding rate.

The Canadian white paper on proposed tax reform issued in 1969 has stated that the 15 percent tax imposed on a NonResident Owned Investment Company will be increased to 25 percent to match a proposed increase in the rate of withholding tax on dividends paid by Candian companies to nonresidents. A capital gains tax for securities is also proposed. The white paper does not indicate any change in the Canadian rules relating to residence for tax purposes, so that corporations incorporated before 1965 will be able to continue to operate as NonResident Corporations not subject to Canadian income tax.

(4) *Cayman Islands.*—The Cayman Islands, like the Bahamas and Bermuda, are within the Sterling Area. There are no income, withholding or estate taxes. There is no applicable U.S. tax treaty. Recent commercial development of the Islands had led to the opening of bank branches and improved communications. The local government appears in agreement with the aims of the business interests developing the Islands and has sought to attract investment income, including the establishment of mutual funds. Since the jurisdiction is little known, it is more often the situs of a management company than fund.

(5) *Channel Islands.*—The Channel Islands have a separate tax regime from Great Britain. The Islands are within the Scheduled Territories and subject to exchange control restrictions. It appears that there has been relatively little use of the Islands by United States promoters and substantial use of the Islands by mutual fund managers in the U.K. There are no income taxes, withholding or estate taxes in the Channel Islands.

(6) *Liechtenstein.*—Liechtenstein remains a flexible tax haven for funds since it does not have any income, withholding or estate taxes applicable to funds. Arrangements may be negotiated directly with the local government concerning the form and activities of a mutual fund, which could be in corporate form or organized as an unincorporated entity. Use of Liechtenstein has been relatively limited, but there is an indication of increased interest in the principality. Liechtenstein

has been widely used by Europeans as a center for investment or holding company operations. The costs of incorporation are relatively substantial and there are annual capital taxes of approximately one percent per year of capital and reserves. Liechtenstein has no income tax treaty with the U.S.

(7) *Liberia.*—There are no income, withholding or estate taxes in the case of a corporation incorporated under the laws of Liberia if it conducts its business outside of Liberia. The corporation law was developed from Delaware corporate law and the U.S. dollar is the official currency. Bearer shares may be issued and a corporation may repurchase and resell its own shares. The sole records that must be maintained in Liberia are the articles of incorporation attested to by the incorporators who may act on behalf of undisclosed principals. A nominal registration tax must be paid each year. There is no income tax treaty between the United States and Liberia.

(8) *Luxembourg.*—Investment funds may be established in Luxembourg in corporate form or as co-proprietorships. Regardless of which form is used. there are no income, withholding or estate taxes in the case of a qualified fund.

In the case of incorporation of a fund in Luxembourg the shares issued on incorporation and increases of capital are subject to a stamp tax of .10 percent and a contribution tax of .32 percent on assets contributed. Each year the assets of the fund are subject to a tax of .16 percent, which can be a significant cost for a large fund.

A substantial operating difficulty arises from the fact that Luxembourg companies cannot purchase their own shares. To operate in the manner of an open-end fund it has become necessary to establish a second Luxembourg company which repurchases shares on redemption by investors. The assets for the repurchases are loaned by the investment company to the repurchase company. The latter subsequently resells the shares it has purchased. Bearer shares are permitted.

Permission has recently been given for holding company tax treatment for advisory companies established as management companies in Luxembourg for the management of a single Luxembourg corporate mutual fund. The taxes on such management companies are limited to the .16 percent tax on the assets of the management company and the investment management fee can be received without Luxembourg income tax. Luxembourg regulations require that the management company manage only one fund, that its shares be registered, that it own an equity interest in the fund which it manages at an minimum amount of $40,000, and that the minimum capital of the management company must be $60,000.

A corporate fund may borrow for leverage. The ratio between the par value of the shares of the corporation and loans obtained by the corporation must be 1 to 3. If bonds are issued the ratio of equity to debt must be 1 to 10. Increases in capital must be made through formal amendment of the articles of incorporation, since the shares cannot be held for any length of time as authorized but unissued.

Funds organized as co-proprietorship (*fonds commun de placement*) require the establishment of a Luxembourg corporate entity as a management company of the fund. The management company is subject to a stamp tax of .10 percent on its capital and to a contribution tax of .32 percent of its capital. No additional taxes whatsoever

are thereafter levied on the management company. The fund itself, which is an unincorporated co-proprietorship similar to a collective investment management account, is subject to an annual tax of .06 percent of the net asset value of the fund.

The relationship of investors to the fund is determined by the provisions of "management regulations" which are signed by the management company and the custodian of the fund's assets and which must be approved by the Luxembourg Ministry of Finance and Banking Commission. Since no corporate form is involved, the co-proprietorship may make a continuous issue of shares and may repurchase its own shares. However, a co-proprietorship cannot borrow for leverage or engage in short sales.

While Luxembourg has an income tax treaty with the United States, holding companies in Luxembourg are subject to the full 30 percent United States withholding tax rate.

(9) *The Netherlands Antilles.*—

(a) *Corporate Aspects.* An open-end mutual fund can be organized in the Netherlands Antilles as a corporation (Naamloze Vennootschap, or "N.V."). Not less than 20 percent of the total authorized capital stock of an N.V., based on par value, must be subscribed for an organization and must remain outstanding at all times. Subject to this restriction, an N.V. may freely redeem shares. Mutual fund shares, whether in bearer or registered form, must be fully paid for at the time of issue. The par value of such shares should be not less than $1.

Open-end mutual funds that have been organized in the Netherlands Antilles normally provide that the fund will redeem shares as long as, after giving effect to such redemptions, not less than 20% of the authorized capital remains issued. A prospectus will frequently state that in the event that the issued capital at any time falls below a specified percentage of the nominal amount of the authorized capital, it would be the intention of the board to take immediate steps to reduce the authorized capital of the fund.

The operation of a Netherlands Antilles N.V. is simlar to that of a Dutch corporation. The N.V. is managed by one or more managing directors, appointed by the shareholders and may, but is not required to, have a Board of Supervisory Directors, to supervise the managing directors. Managing directors may be corporate persons, that is, banks, underwriting firms, etc.

The capital of an N.V. may be expressed in anv currency.

The fund's charter must be approved bv the Ministers of Justice, which can take time. The name of the fund and the charter can be in English.

The principal cost of organization consists of a graduated notarial fee based on the Company's capital. In the case of a mutual fund, this fee is based on the initial amount to be paid in for the Fund's authorized shares. The fee on a capital of $500,000 is approximately $1,000, and $250 is payable for each additional $500,000. In addition, upon registration in the Registry of Commerce a fee is payable to the Chamber of Commerce, based on the amount of paid in capital, and an annual contribution is payable thereafter. On paid in capital of $1

million, the initial contribution is $500 and the annual contribution is $50.

(b) *Tax Aspects.* Dividends paid by a Netherlands Antilles company to nonresidents of the Netherlands Antilles are not subject to any withholding tax.

No Netherlands Antilles gift, estate or inheritance taxes are imposed on shareholders who are not domiciled in the Netherlands Antilles.

A Netherlands Antilles fund would qualify for taxation as an "investment company," the income of which would be taxed as follows:

(a) Capital gains are not subject to taxation.

(b) Dividends received by the fund from U.S. sources are, under the tax treaty, subject to U.S. withholding tax of 15%, provided that the Fund elects to pay Netherlands Antilles tax at 15% on its net dividend income (after deduction of U.S. withholding tax and allocable expenses). The total maximum effective rate is said to be about 20 percent.

(c) U.S. source interest received by the Fund is free of U.S. withholding tax under the tax treaty, provided that the Fund elects to pay Netherlands Antilles income tax of 24% on the first $53,000 of such U.S. source net interest income and of 30% on amounts in excess thereof (protocol of October 23, 1963 to the tax treaty).

(d) Dividends and interest received by the fund from non-U.S. sources, or from U.S. affiliated companies such as the international financing companies used for the issue of Eurodollar debentures that are not subject to U.S. withholding tax, are subject to Netherlands Antilles tax of 2.4% on the first $53,000 of such net interest and dividend income and of 3% on amounts in excess thereof.

The Netherlands Antilles imposes no annual capital or net worth taxes.

Securities issued in the Netherlands Antilles are subject to a stamp tax of 4 per mill of par value. Thus, if the fund maintains its stock transfer books in the Netherlands Antilles and issues its shares there, this tax would be applicable. If the shares of the Fund have a par value of $1, the stamp tax on the issue of 100 shares would be $0.40.

In addition, the Netherlands Antilles tax authorities have recently indicated that a locally incorporated management company of an Antilles fund could, under specified circumstances, be taxed on the same basis as an Antilles mutual fund.

(10) *Panama.*—Panama levies no taxes on the income of a foreign owned corporation operating outside of Panama, nor are there withholding or estate taxes. The cost of maintaining the Panamian corporation is negligible. Panama has no tax treaties and the full 30 percent U.S. withholding tax is applicable. No record-keeping is required in Panama and no Panamanian directors or officers are required.

Panama is often selected as a situs for management or sales companies. The question of political stability is reportedly one that has tended to limit its use as a situs for the mutual fund themselves, although some funds have been incorporated there.

(11) *Switzerland.*—In 1966, the Swiss enacted a Federal Investment Fund Act. The Act authorizes creation of an investment fund by the transfer of funds by investors to a management company in exchange

for interests in the fund represented by freely transferable shares. The fund structure resembles the co-proprietorship form used in Luxembourg, except that there is specific detailed legislation in Switzerland providing for the fund. A majority of the directors of the management company must be Swiss citizens. The Internal Revenue Service has ruled that a fund established under the Swiss provisions constitutes an association taxable as a corporation for United States income tax purposes.

Provided that such a fund derives more than 80 percent of its income from sources outside of Switzerland and provided that realized capital gains are distributed, the fund is not subject in Switzerland to any tax on net worth, capital gains, or income, nor are the owners of shares of the fund subject to Swiss estate or gift taxes. Under the income tax treaty between the United States and Switzerland, dividends are subject to 15 percent United States withholding tax and interest is subject to a 5 percent withholding tax.

It is also possible to establish a fund in Switzerland in a purely corporate form. There would be an annual Federal tax on the capital and reserves of the corporation at the rate of .0675 percent. Federal and cantonal tax would also be imposed on the profits earned each year. The rate of such taxes are subject to negotiation but could be expected to be in excess of 3 percent. Dividend distributions would be subject to the Swiss withholding tax at the rate of 30 percent.

6. Regulations in the Country Where Sold

In recent years, a spate of restrictions have gone up in Europe to counter, restrict, or hinder sales by offshore funds in domestic national markets. The reasons given have been (1) protection of the investors; (2) protection of the domestic capital market and savings flows; and (3) balance of payments considerations. By way of example only, specific restrictions on the activity or sale of shares of offshore funds have been introduced in the past three years in Sweden, Norway, Germany, Switzerland, Italy, Austria, and the U.K. Other countries, including France, maintain more general exchange controls and other restrictions that, as part of their impact, also restrict the sale of offshore fund shares.

One response to this development has been the establishment by offshore fund management companies of domestic investment funds designed specifically to fulfill the legal restrictions and requirements for operation in a given country's market. This is particularly true of operations in the German, Italian, and Swiss markets where, if the sometimes severe requirements can be met, foreign funds are still permitted to sell their shares to residents. However, not all countries offer even this option.

H. STATISTICAL ANALYSIS OF THE BALANCE OF PAYMENTS AND CAPITAL MARKET IMPACT OF OFFSHORE FUNDS

Foreign purchases of U.S. securities have grown markedly in recent years and have been a positive element in the U.S. balance of payments. U.S. Treasury data shows that net foreign purchases of cor-

porate and other securities totaled $4.2 billion in 1968 and $2.7 billion in 1969. Of this, net foreign purchases of U.S. stock were $2.3 billion in 1968 and $1.5 billion in 1969.[26]

This section analyzes the importance of identified offshore fund activity within overall foreign purchases and sales of securities in the U.S. market for a 26-month period, from January 1968 through February 1970. It indicates the value of reported offshore fund holdings of U.S. securities as a percentage of total foreign holdings of U.S. securities in December 1967, 1968 and 1969; gives an indication of the growth of the number of offshore funds involved in the U.S. market; the degree of U.S. broker and bank involvement; and a summary assessment of the relative importance of offshore funds in comparison to certain categories of U.S. institutional investors.

The difficulties experienced by the Study in obtaining information on offshore fund activities are set forth in part A of this chapter. We assume that the reported data that follows on offshore funds consistently understates the importance of offshore funds as a factor in the U.S. Market.

The data and percentages presented in this section are not scientifically precise. Rather, they are indicative of magnitudes and trends represented by the activity of those offshore funds reported to the Study. Thus, while the data gives an accurate impression of the offshore fund activity known to the banks and brokers in the U.S. that replied to the Study's questionnaire, it is clearly not complete.

1. The Total Value of Offshore Fund Holdings

The value of the total assets of all offshore funds, including real estate funds, has been estimated at $6 billion at the end of 1969.[27] This figure includes holdings of foreign as well as domestic securities, real estate, and cash. An analysis of the total holdings of 178 offshore funds (including real estate funds) as of December 31, 1969 placed the value of total disclosed assets at $4.7 billion.[28] The Study's analysis shows the value of reported offshort fund holdings of U.S. securities with U.S. custodians in December 1969 to be $2.7 billion. Offshore funds undoubtedly held additional U.S. securities not identified to the Study (because they were held by foreign custodians or in a foreign bank name).

These figures indicate that the total value of offshore fund holdings as a group exceeds the net asset value of open end investment companies in any individual country of the world except the U.S.

This statement may be somewhat misleading because in certain major countries, including Switzerland and the U.K., the legal structure of certain important funds may not be akin to an open-ended fund. The following table [29] gives a relative breakdown of the net asset value of open-end funds in major selected industrialized coun-

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[26] Treasury Bulletin. August, 1970, p. 114.

[27] Lee, John M.. "Offshore Funds, Assets Sag"; "I.O.S. Promises Further Data". *New York Times*, June 18, 1970, at 67.

[28] *The Intervestment Management Analysis of Offshore Funds*, July 1, 1970.

[29] Data on national funds are from the *Quarterly Report on Mutual Funds Around the World*, Research Department, Investment Company Institute, March 11, 1970. The offshore fund estimate is based on the *Intervestment Management Analysis of Offshore Funds*, July 1, 1970. There may be some double-counting involved in the figures, but not enough to change the relative rankings.

tries and the estimated assets of all offshore funds (some of which are not open-ended) on December 31, 1969.

	(Billions of U.S. dollars)
1. United States	48.3
2. Offshore funds (estimate)	5–6
3. Japan	3.4
4. Great Britain	3.4
5. Germany	2.5
6. Canada	2.5
7. France	1.0

2. Importance of Offshore Fund Holdings of U.S. Securities

The value of offshore funds holdings of all U.S. securities including U.S. equities, has increased markedly from December 1967 to December 1969, although offshore funds as a group tended to keep most of their U.S. securities holdings in stock.

The estimated value of offshore fund holdings of U.S. securities held by U.S. custodians was as follows:

[Dollar amounts in millions]

	All U.S. securities	U.S. equities	Percent in equities
December 1967	$978	$896	92
December 1968	2,057	1,824	87
December 1969	2,667	2,347	88
February 1970	2,345	2,112	90

The variation in the value of offshore holdings reflects not only changes in the volume and direction of capital flows, but also changes in the market value of the securities held in the portfolio.

It is clear that the value of reported offshore fund holdings of U.S. equities have in the 1967–1969 period increased at a faster rate than the value of all foreign holdings of U.S. equities, growing from 6 percent of foreign equity holdings in 1967 to 13 percent in 1969.

[Dollar amounts in billions in U.S. equities]

	December 1967	December 1968	December 1969
1. All foreign holdings [1]	$15.5	$19.5	$18.1
2. Identified offshore funds	$0.9	$1.8	$2.3
3. Percent (2/1)	6	9	13

[1] Survey of Current Business, October 1969, at 24; October 1970, at 23.

The value of the equity holdings of the offshore funds increased by $0.9 billion in 1968 (a growth of 100 percent over 1967) and by $0.5 billion in 1969 (growth of 28 percent over 1968). The decline in the rate of growth of the holdings is of course not unusual in light of the absolute decline in stock values in the U.S. market in 1969, and the change in the size of the statistical base.

Table VII–1A. sets forth the estimated value of all U.S. securities and of U.S. equities held by U.S. custodians on behalf of identified offshore funds, by place of the funds' legal domicile, in December 1967,

1968, 1969 and on February 28, 1970. It also shows the growth in the number of funds by year, by place of domicle.

The growth of the holdings of funds domiciled in Luxembourg, Switzerland, the Bahamas, Bermuda, and the Netherlands Antilles is striking, although not unexpected in light of the developments outlined in this chapter. The reduction in the value of holdings of funds in February, 1970 may be a reflection of changes in portfolio composition (into liquid assets or foreign securties) as well as the overall decline in the value of U.S. securities.

Table VII–1B. shows the data in Table VII–1A. in terms of percentages increase or decrease of the value of total holdings. As noted, the almost universal decline in value from December 1969 to February 1970 in part reflects market price trends.

3. The Relative Size of the Funds

The relative size of the funds' holdings and the growth in the number of funds identified by U.S. custodians is shown in Table VII–2. The field is dominated in terms of asset size by a few large funds, with a steady increase in the number of funds in the lower-medium range whose assets have steadily increased. The larger number of funds in the lower asset categories is indicative of the increasing number of offshore funds entering the field during the period under review.

In terms of the average size of U.S. mutual funds' asset holdings, all but the largest offshore funds are quite small in comparison.

4. U.S. Custodians of Offshore Funds' Assets

The number of banks and brokers in the U.S. which act as custodians or subcustodians for offshore funds is small, and largely centered in New York. Table VII–3 summarizes the details. A few custodian banks hold most of the assets, although some newer offshore funds have utilized custodians not previously active in offshore fund acounts.

5. The Role of Brokers in the U.S.

The Study tried to reach all brokers that transact business for offshore funds in the U.S. market; 292 brokers reported at least one trade on behalf of offshore funds. Brokerage for offshore funds was concentrated in New York. Brokerage firms throughout the U.S., in the New England States, the deep south, Texas, in the middle west and on the Pacific Coast also reported trading.

Some of the regional brokers speculated that they received specific orders because of local research, because they make a market in a given regional company's stock, or, in some cases because a salesman had been particularly aggressive in seeking out new clients.

Research, good execution, making markets in an over-the-counter or foreign security, aggressive sales, personal or business realtionships, or some affiliation with an offshore fund were factors cited by brokers in New York. As would be expected, the larger, internationally connected houses have more of the offshore business, although some offshore funds seem to concentrate their orders through smaller brokerage firms.

Tables VII–5 and VII–6 have columns entitled "Fund Activity", which indicate the number of times that brokers reported an individual offshore fund or a financial institution acting on behalf of an offshore fund had placed at least one order during a given month (that is, if a given offshore fund placed 10 individual orders with 10 brokers during a month, this would represent 10 indications of fund activity; if the same fund placed 10 orders during the month with only one broker, there would be only one indication of fund activity). The growth of "fund activity" as defined above more than doubled from 1968 to 1969.

During the period covered by the Study, banks and brokers reported activity on behalf of 450 offshore funds, either by fund name or in the name of financial institutions placing orders on their behalf. An additional 86 funds were dropped from the Study because they did not meet the Study's definition of an offshore fund or were consolidated to avoid double counting.

In addition, 29 Fund of Funds "prop funds" were reported and consolidated under Fund of Funds. At least 20 brokers reported activity for funds in the I.O.S. complex in the name of either a European or U.S. financial institution. All identified I.O.S. activity except for national funds set up by the offshore parent company are included under Switzerland. This parallels the treatment of the I.O.S. complex under the Treasury's overall foreign reporting system with which the figures are compared.

6. Offshore Funds' Impact on the U.S. Balance of Payments and Capital Market

The offshore funds' activity in the U.S. market is primarily centered on the purchase and sale of U.S. stock, although other types of securities are also purchased and sold. Table VII–4 shows the importance of reported offshore fund activity for calendar years 1968 and 1969 in relation to all foreign purchases and sales of certain types of securities reported to the Treasury Department.

Table VII–5 sets forth the monthly details on the four categories of securities analyzed from January 1968 to February 1970. The totals in Table VII–6A and VII–6B show offshore funds' reported purchase and sale of U.S. stock as a percentage of all foreign purchases and sales of U.S. stock reported to the Treasury Department.

In some cases, the offshore funds' purchases and sales ran counter to the transactions reported by other foreign investors (that is, offshore funds showing net purchases when other foreigners were making net sales and vice versa).

7. Geographic Importance of the Offshore Domiciles

The location of an offshore fund domicile does not necessarily indicate anything about the source of the cash being invested. The funds themselves often act as a conduit for money originating in other corners of the globe, including Europe, the Middle East, Asia, South America and perhaps even Africa.

It was not possible for the Study to identify the original source of the offshore funds' assets invested in the U.S. Some knowledgeable

observers presume that most cash flowing to funds domiciled in Luxembourg and Switzerland comes from Europe and the Middle East, with perhaps more South American money going to funds in the Caribbean area than elsewhere, but this is conjecture rather than demonstrated fact.

Table VII–6 is set up on a basis comparable to the presentation in the *Treasury Bulletin.* It shows purchases and sales of U.S. equities by offshore funds as reported to the Study, compared with purchases and sales of U.S. equities by all foreigners as reported to the Treasury Department. Because of differences in the sources of the data, comparison of the two series is subject to substantial qualifications.

Although total transactions by offshore funds in U.S. equities shown in the Study may be a reasonable proportion of total transactions by all foreigners as reported to the Treasury Department, the amounts reported in some instances in the Study exceed the totals published in the *Treasury Bulletin* for the same countries. There are several reasons for such discrepancies.

The Treasury data are reported principally by brokers, dealers and banks, the institutions which constitute the major channels for foreign transactions in U.S. equities. The Study was also addressed to brokers, dealers and banks, but in the course of the cross-checking described above, reached a number of firms not included in the Treasury data, In addition, the fact that the Treasury report form has a minimum exemption level, whereas the Study asked for information on all offshore fund transactions regardless of amount, would also tend to produce the same result. Finally, the country distribution of the data reported in the two series may differ because of differences in the classification of reported transactions by country. Country classifications are not always clear-cut and obvious in many reporting situations, and it is possible that the respondents to the Study may have classified transactions by country differently than respondents on the Treasury form. In view of these uncertainties, comparison of the two series can be made only on a tentative basis.

Data on individual countries has been included in Table VII–6 because either (a) the absolute dollar amounts involved are relatively large (that is, Switzerland) or (b) both dollar amounts and percentage of offshore activity are consistently significant as a percentage of all transactions from a given domicile (that is, the Netherlands Antilles).

Data on the U.K., Panama, and Canada are included, but they are minimal. Offshore fund activity in these countries has been noticeable in a few given months, but only infrequently. In the case of the U.K., in early 1968, it is probable that the purchase and sales were placed through London on behalf of offshore funds domiciled elsewhere.

The data does not include information on the extent to which offshore funds have purchased Euro-bonds or convertible debentures issued in Europe by foreign affiliates of U.S. companies. Some funds specialize in these type securities; others include them in their portfolios. To the extent that they do, the U.S. balance of payments is indirectly assisted.

One conclusion clearly evident from Tables VII–4, 5, and 6 is that reported offshore transactions accounted for about 27 percent ($605

million) of net foreign purchases of U.S. stock in 1968 and 36 percent ($534 million) in 1969.[32] The sums involved were of course inflows in the U.S. balance of payments. It is particularly interesting that net offshore purchases as a percentage of all foreign purchases increased at the same time that all net foreign purchases declined (from $2.3 billion to $1.5 billion).

It is impossible to judge (a) how much of the increased purchases by offshore funds represent a substitution from other channels for investment that also would have made purchases of U.S. equities and (b) how much represents a net new flow of capital that would not have found its way into U.S. equities in the absence, say, of the aggressive marketing techniques of some offshore funds that have tapped new sources of savings not normally flowing to the U.S. market. Some element of each is undoubtedly reflected in the figures.

8. The Activity of Offshore Funds in the U.S. Capital Markets

This is not a study of considerations that lead foreign investors to purchase U.S. securities rather than make other investments, although these factors do have an influence in determining offshore funds' portfolio management strategy. In general terms, they include the depth and the liquidity of the U.S. market: In contrast to most foreign markets, large sums of money can usually be invested quickly in the U.S. without markedly driving up the price of the securities purchased; large blocks of shares can usually be sold without overly depressing the price.

Foreigners, when looking at other investment alternatives, take into account the performance and trends of the European, Canadian, Japanese, Australian and South African markets; the securities issued in Europe by U.S. companies or affiliates (including convertible debentures); the interest rates on foreign bonds and on the Euro-dollar market; and the relative strengths and weaknesses of national exchange rates. These variables are mentioned to help place in perspective the concatenation of interrelationships and alternatives that an offshore fund portfolio manager may consider before deciding to purchase or sell a specific U.S. stock.

Table VII-7 shows the relative importance of offshore funds' purchases and sales of U.S. common stock in relation to selected U.S. financial institutions and all foreign investors quarterly and for the year 1969.

Total foreigners' and life insurance companies' net acquisitions were about the same in 1969, but all foreign transactions (purchases and sales) were four times as great as those by life insurance companies.

The data does support the assumption that offshore funds have a very high activity ratio in relation to total assets. Bearing in mind that the data is not complete nor entirely comparable, total purchases and sales of common stock by offshore funds in 1968 and 1969 in relation to the value of estimated year end holdings of common stock reported

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[32] Bear in mind that the data being compared are not from the same statistical population. Study reported data came from more respondents. On the other hand, there probably are offshore fund transactions included in the Treasury data that were not reported to us. The comparisons do, however, seem fair in terms of assessing general orders of magnitude.

by the offshore fund U.S. custodians shows an activity rate of 121 percent in 1968 and 151 percent in 1969. These percentages have an upward bias in them because the U.S. custodian data understates total offshore fund holdings of U.S. equities, but (even allowing for a 100 percent understatement in the value of holdings) these activity rates are clearly higher than those of U.S. open-end investment companies during the same period, 44 percent in 1968 and 53 percent in 1969. The activity rate for all foreign investors was 62 percent in 1968 and 65 percent in 1969.[33] Based on this rough measure, the expectation that offshore funds trade more actively (due in part to the lack of capital gains tax considerations) seems to be borne out.

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[33] The rough activity ratios are computed by adding the purchases and sales of stock for the year in question, then dividing by the value of common stock holdings at the end of the year, then dividing by 2.

Thus, for offshore funds, $6.922 billion divided by $2.347=295 percent in 1969; $4,426 billion divided by $1,823 billion=243 percent in 1968; see Table 1A. and 5A. Then divided by 2.

For U.S. open-end funds $41.910 billion divided by $39.669 billion=106 percent in 1969; $38.595 billion divided by $44.407 billion=87 percent in 1968. Then divided by 2. Source: Investment Company Institute.

For all foreign investors, $23.5 billion divided by $18.1 billion in 1969 and $24.0 billion divided by $19.5 billion in 1968, then divided by 2.

TABLE VII-1A

ESTIMATED VALUE OF ALL U.S. SECURITIES AND U.S. EQUITIES HELD IN THE U.S. ON BEHALF OF OFFSHORE FUNDS, BY PLACE OF DOMICILE DECEMBER 1967, DECEMBER 1968, DECEMBER 1969, FEBRUARY 28, 1970

(THOUSANDS OF DOLLARS) 34/

COUNTRY OF DOMICILE	DECEMBER 1967				DECEMBER 1968				DECEMBER 1969				FEBRUARY 28, 1970			
	# of Funds	All U.S. Securities	U.S. Equities	Equit. as %	# of Funds	All U.S. Securities	U.S. Equities	Equit. as %	# of Funds	All U.S. Securities	U.S. Equities	Equit. as %	# of Funds	All U.S. Securities	U.S. Equities	Equit. as %
Belgium	3	14,224	12,306	87	3	17,089	16,400	96	4	17,965	17,173	97	4	17,286	16,682	97
Luxembourg	3	43,449	37,249	86	12	154,277	122,702	80	35	252,150	210,531	84	36	263,913	231,328	88
Switzerland	6	686,416	630,220	92	10	1,173,645	1,083,545	92	23	1,214,831	1,138,816	94	25	1,084,161	1,006,784	93
Bahamas	13	90,113	89,353	99	27	390,033	312,416	80	46	644,213	514,856	80	45	466,916	409,553	89
Bermuda	3	16,012	12,230	76	7	81,629	67,339	82	20	146,671	121,872	83	21	136,900	115,422	84
Netherlands Antilles	9	106,449	99,993	94	20	204,659	192,412	94	46	271,132	235,337	87	46	257,778	226,037	88
Canada	2	5,405	5,405	100	2	11,642	11,642	100	5	73,672	66,694	91	5	72,540	65,954	91
Other	3	15,945	9,344	59	6	24,189	17,335	72	12	46,810	41,318	88	14	45,012	39,963	89
TOTAL	42	978,013	896,100	92	87	2,057,163	1,823,791	87	191	2,667,484	2,346,597	88	196	2,344,506	2,111,7[illegible]3	90

TABLE VII-1B

PERCENTAGE INCREASE OR DECREASE IN THE REPORTED OFFSHORE FUND HOLDINGS OF U.S. SECURITIES AND US EQUITIES FROM 1967 TO 1969, AND FIRST TWO MONTHS 1970

	DEC. 1968 AS COMPARED TO DEC. 1967		DEC. 1969 AS COMPARED TO DEC. 1968		FEB. 1970 AS COMPARED TO DEC. 1969	
	Securities	Equities	Securities	Equities	Securities	Equities
Belgium	20	33	5	5	-4	-3
Luxembourg	255	229	63	72	5	10
Switzerland	71	74	3	4	-11	-12
Bahamas	333	250	70	69	-28	-20
Bermuda	410	451	80	81	-7	-5
Netherlands Antilles	92	92	32	22	-5	-4
Canada	115	115	533	473	-2	-1
Other	52	52	94	138	-4	-3
TOTAL	110	105	30	29	-12	-10

34/ Securities include the value of all U.S. securities in the portfolio having a maturity greater than one year (cash and other short-term assets are excluded). Convertible debentures are considered bonds (not equities).

TABLE VII-2

Identified Number of Funds Holding U.S. Securities by Value of Holdings of U.S. Securities in December 1967, 1968 and 1969

	December 1967	December 1968	December 1969
	Number	Number	Number
$500 MM - OVER	1	1	1
$400 MM - $500	-0-	-0-	-0-
$300 MM - $400	-0-	-0-	-0-
$200 MM - $300	-0-	1	1
$100 MM - $200	-0-	-0-	2
$ 75 MM - $100	1	?	1
$ 50 MM - $ 75	1	-0-	2
$ 25 MM - $ 50	1	10	11
$ 9 MM - $ 25	10	24	33
Below 9 million	28	49	135
TOTALS	42	87	191

NOTE: The total values of holdings of U.S. securities for each year are the same as those shown on Table VII-1a

TABLE VII-3

Number of Banks and Brokers in the U.S. Acting as Custodian or Subcustodian for Offshore Funds, by Total Value of Holdings of U.S. Securities and the Number of Funds Involved

Value of Accounts	December 1967		December 1968		December 1969	
	Number of Custodians	Number of Funds	Number of Custodians	Number of Funds	Number of Custodians	Number of Funds
$500 MM - OVER	1	3	1	5	1	11
$400 MM - $499						
$300 MM - $399					1	20
$200 MM - $299					1	9
$100 MM - $199			2	15	1	9
$ 75 MM - $ 99			1	5	1	12
$ 50 MM - $ 74	3	14	1	6	3	13
$ 25 MM - $ 49	2	7	7	18	8	35
$ 10 MM - $ 24	3	4	12	24	14	29
$ 0 MM - $ 9	10	14	13	14	38	53
TOTALS	19	42	37	87	68	191

NOTE: The total values of U.S. securities for each year are the same as those shown on Table VII-1a

TABLE VII-4

REPORTED OFFSHORE FUND ACTIVITY IN RELATION TO ALL FOREIGN PURCHASES AND SALES OF CERTAIN TYPES OF SECURITIES

	1968 _/	1969 _/
(a) U. S. Stock ($ millions)		
Gross Foreign Purchases	13,118	12,429
Offshore Fund Purchases	2,516	3,728
Percent	19%	30%
Gross Foreign Sales	10,848	10,942
Offshore Fund Sales	1,911	3,194
Percent	18%	30%
Net Foreign Purchases	2,270	1,487
Net Offshore Fund Purchases	605	534
Percent	27%	36%
(b) U. S. Corporate Bonds ($ millions)		
Gross Foreign Purchases	4,446	3,055
Offshore Fund Purchases	111	114
Percent	3%	4%
Gross Foreign Sales	2,481	1,853
Offshore Fund Sales	123	104
Percent	5%	6%
Net Foreign Purchases	1,964	1,202
Net Offshore Fund Purchases	12	11
Percent	0.6%	0.9%

_/ Gross and net foreign data are from the Treasury Bulletin, July 1970, p. 109.

TABLE VII-4 (CONTINUED)

REPORTED OFFSHORE FUND ACTIVITY IN RELATION TO ALL FOREIGN PURCHASES AND SALES OF CERTAIN TYPES OF SECURITIES

(c) Foreign Stock ($ millions)		
Gross Foreign Purchases	1,252	1,519
Offshore Fund Purchases	43	180
Percent	3%	12%
Gross Foreign Sales	1,566	2,037
Offshore Fund Sales	31	137
Percent	2%	7%
Net Foreign Purchases	-314	-517
Net Offshore Fund Purchases	12	42
Percent	-%	-%
(d) Foreign Bonds ($ millions)		
Gross Foreign Purchases	2,306	1,552
Offshore Fund Purchases	30	50
Percent	1%	3%
Gross Foreign Sales	3,686	2,568
Offshore Fund Sales	37	40
Percent	1%	2%
Net Foreign Purchases	-1,380	-1,016
Net Offshore Fund Purchases	-7	10
Percent	0.5%	-%

TABLE VII-5 35/

IDENTIFIED PURCHASES AND SALES OF U S. AND FOREIGN LONG-TERM SECURITIES IN THE U.S. MARKET BY OFFSHORE FUNDS; (thousands of dollars) January 1968 - February 1970

		Fund Activity	Net. Pur. of U.S. Corporate and other Securities	U.S. CORPORATE AND OTHER SECURITIES – BONDS			STOCKS			Net Purchase of Foreign Securities	FOREIGN SECURITIES – BONDS			STOCKS		
				Net Purchases	Gross Purchases	Gross Sales	Net Purchases	Gross Purchases	Gross Sales		Net Purchases	Gross Purchases	Gross Sales	Net Purchases	Gross Purchases	Gross Sales
				1				5	6	7	8	9		11	12	13
1968	January	112	9,697	-199	5,700	5,899	9,896	143,049	133,153	-2,496	-1,086	476	1,562	-1,410	256	1,666
	February	121	34,141	400	4,207	3,807	33,741	143,407	109,666	-1,085	-717	631	1,348	-368	134	502
	March	117	18,683	9,328	13,727	4,399	9,355	141,526	132,171	-2,303	-3,094	1,073	4,167	791	1,483	692
	April	142	151,925	1,398	13,086	11,688	150,527	284,145	133,618	4,731	911	3,460	2,549	3,820	4,182	362
	May	184	35,189	-2,919	10,869	13,788	38,108	252,479	214,371	4,221	-314	3,558	3,872	4,535	9,499	4,964
	June	176	51,322	-5,601	6,602	12,203	56,923	235,726	178,803	-1,123	-2,744	3,213	5,957	1,621	4,446	2,825
	July	192	62,727	2,539	5,501	2,962	60,188	213,888	153,700	-247	-200	3,358	3,558	-47	2,133	2,180
	August	185	-14,354	2,577	9,793	7,216	-16,931	142,129	159,060	2,170	1,746	3,595	1,849	424	3,949	3,525
	September	195	28,370	827	6,730	5,903	27,543	185,356	157,813	612	1,883	4,491	2,608	-1,271	2,325	3,596
	October	205	93,115	-12,677	12,284	24,961	105,792	294,181	188,389	-2,131	-2,406	1,060	3,466	275	4,324	4,049
	November	229	54,029	-6,059	9,911	15,970	60,088	196,949	136,861	1,435	-291	2,854	3,145	1,726	4,072	2,346
	December	265	68,655	-1,329	12,647	13,976	69,984	283,006	213,022	1,603	-893	1,988	2,881	2,496	6,289	3,793
	TOTAL	2,123	593,499	-11,715	111,057	122,772	605,214	2,515,841	1,910,627	5,387	-7,205	29,757	36,962	12,592	43,092	30,500
1969	January	270	38,224	1,487	5,892	4,405	36,737	275,345	238,608	-1,931	-155	1,813	1,968	-1,776	4,699	6,475
	February	339	62,272	-6,582	6,770	13,352	68,854	268,838	199,984	-1,804	-1,911	3,046	4,957	107	9,469	9,362
	March	311	-2,694	5,789	11,023	5,234	-8,483	205,503	213,986	10,079	-13	1,275	1,288	10,092	14,691	4,599
	April	416	44,245	-2,389	9,208	11,597	46,634	256,994	210,360	8,704	-44	706	750	8,748	17,906	9,158
	May	496	187,846	-1,181	10,956	12,137	189,027	448,473	259,446	13,634	3,482	3,664	182	10,152	28,922	18,770
	June	474	-88,876	-1,103	7,036	8,139	-87,773	260,083	347,856	6,019	14,143	17,502	3,359	-8,124	23,160	31,284
	July	471	-15,886	522	6,268	5,746	-16,408	270,624	287,032	3,108	-6,581	9,158	15,739	9,689	20,365	10,676
	August	481	34,982	3,617	10,830	7,213	31,365	297,130	265,765	-2,855	-82	2,006	2,088	-2,773	14,541	17,314
	September	508	119,832	-684	10,928	11,612	120,516	458,218	337,702	4,252	1,153	1,704	551	3,099	9,168	6,069
	October	603	157,928	-517	12,581	13,098	158,445	437,340	278,895	-4,032	-129	1,773	1,902	-3,903	10,766	14,669
	November	537	35,305	3,251	7,257	4,006	32,054	286,024	253,970	6,785	-2,331	3,314	5,645	9,116	13,039	3,923
	December	615	-28,998	8,426	15,621	7,195	-37,424	263,363	300,787	11,188	2,918	4,506	1,588	8,270	13,116	4,846
	TOTAL	5,521	544,180	10,636	114,370	103,734	533,544	3,727,935	3,194,391	53,147	10,450	50,467	40,017	42,697	179,842	137,145
1970	January	542	3,757	-4,455	11,469	15,924	8,212	250,597	242,385	-6,901	-2,108	905	3,013	-4,793	5,176	9,969
	February	529	-39,599	-85	10,060	10,145	-39,514	212,565	252,079	-189	1,611	2,098	487	-1,800	3,787	5,587
	TOTAL	1,071	-35,842	-4,540	21,529	26,069	-31,302	463,162	494,464	-7,090	-497	3,003	3,500	-6,593	8,963	15,556
	GRAND TOTAL	8,715	1,101,837	-5,619	246,956	252,575	1,107,456	6,706,938	5,599,482	51,444	2,748	83,227	80,479	48,696	231,897	183,201

35/ The reported figures on gross offshore fund purchases and gross offshore fund sales include an unknown amount of transactions between foreigners effected through U.S brokers The figures on net purchases by all foreigners represent transactions between foreigners and residents of the U.S. The figures on net purchases for individual countries, however, may include some of the transactions between foreigners, and therefore may not be a precise indication of the amount of transactions between residents of the individual country and residents of the U.S.

TABLE VII-6A[1/]

TRANSACTIONS IN U S STOCK BY IDENTIFIED OFFSHORE FUNDS, BY COUNTRY OF DOMICILE, COMPARED WITH ALL U.S. STOCK PURCHASED FROM THE COUNTRY OF DOMICILE, (MILLIONS OF DOLLARS) January 1968 - February 1970

Country		1968 Jan.	Feb.	Mar	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	1969 Jan.	Feb	Mar.	April	May	June	July	Aug.	Sept.	Oct	Nov.	Dec	1970 Jan.	Feb.
(a) BELGIUM and (b) LUXEMBOURG																											
(a & b)	Gross Purchases - Total	11	8	22	30	35	34	37	24	24	28	24	61	65	78	81	56	106	52	51	75	80	93	73	41	29	33
(a) Belgium	Gross Pur -Offshore Funds	.1	1.3	4	.1	.6	.4	.1	.1	.5	1	.1	1.9	2.1	.9	.9	.7	.7	.8	.1	1	1.4	.5	.7	.3	.4	.1
(b) Luxembourg	Gross Pur.-Offshore Funds	6 0	9.5	14.7	15.8	18.3	25.4	23.8	9.5	12.2	11.0	16.8	30.4	18.7	17.7	10.5	21.3	36.7	16.5	23.8	12 5	14.3	28.8	44.5	24.7	21.9	26.1
	Total Offshore	6 1	10.8	15.1	15.9	18.9	25 8	23.9	9.6	12.7	11.1	16.9	32.3	20 8	18.6	11.4	22.0	37.4	17.3	23.9	12.6	15.7	29 3	45.2	25.0	22.3	26.2
(a & b)	Gross Sales - Total	8	6	16	32	34	34	28	12	18	27	16	27	62	47	54	39	54	25	79	41	58	80	47	41	48	50
(a) Belgium	Gross Sales -Offshore Funds	.3	.3	.2	1.3	.9	.1	.4	.4	.2	.1	.6	2.9	.3	.3	.2	6	1.1	.7	.6	.5	.5	.4	1.3	0	0	.3
(b) Luxembourg	Gross Sales -Offshore Funds	9.4	3.4	6.6	11 9	13.4	15.0	12.6	9.4	8.3	12.7	11.5	11.6	13.8	11.4	8.4	8.9	9.4	10.4	11 3	10.7	14.2	18.3	22.6	18.1	18.7	14.9
	Total Offshore Funds	9.7	3.7	6.8	13.2	14.3	15.1	13.0	9.8	8.5	12.8	12.1	14.5	14 1	11 7	8.6	9.5	10.5	11.1	11 9	11.2	14.7	18.7	23.9	18.1	18.7	15.2
	Net Purchases - Total	3	2	6	-2	1	--	9	12	6	1	8	34	3	31	27	17	52	27	-28	34	22	13	26	--	-19	-17
(a) Belgium	Net Pur.-Offshore Funds	-.2	1.0	.2	-1.2	-.3	.3	- 3	-.3	-.3	0	-.5	-1.0	1.8	.6	.7	.1	-.4	.1	-.5	-.4	.9	.1	- 6	.3	.4	-.2
(b) Luxembourg	Net Pur.-Offshore Funds	-3.4	6 1	8.1	3.9	4.9	10.4	11.2	.1	3 9	-1.7	5.3	18 8	4.9	6.3	2.1	12.4	27.3	6.1	12.5	1.8	.1	10.5	21.9	6.6	3.2	11.2
	Total Offshore Funds	-3.6	7.1	8.3	2.7	4.6	10.7	10.9	- 2	4.2	-1 7	4.8	17.8	6.7	6.9	2.8	12.5	26.9	6.2	12.0	1.4	1.0	10.6	21.3	6.9	3.6	11.0
	Fund Activity	180												555												140	
FRANCE	Gross Purchases - Total	62	46	55	71	68	44	67	40	63	83	106	75	54	49	42	44	46	31	27	95	47	64	47	54	44	63
	Gross Pur.-Offshore Funds			.7	.5	.3	0	.1	.2	.3		0.	7.1	.5	1.8	1.8	.8	1.9	.9	.5	.2	.9	1 1	.5		1.0	1.5
	Gross Sales - Total	56	34	50	49	63	30	46	25	38	73	59	55	45	40	38	39	43	41	22	19	26	52	47	40	43	54
	Gross Sales-Offshore Funds			.7	1.6	.3	.2	3	0	.2		1.0	.6	.1	.1	0	.1	0	.9	.4	.0	1 0	.7	0		.1	1.4
	Net Purchases - Total	6	12	5	22	5	14	21	15	25	10	47	20	9	9	4	5	3	-10	5	76	21	12	--	14	1	9
	Net Pur.-Offshore Funds			0	-1.1	0	-.2	-.2	.2	.1		-1.0	6.5	.4	1.7	1.8	.7	1.9	0	.1	.2	-.1	.4	.5		9	.1
	Fund Activity	10												38												9	
GERMANY	Gross Purchases - Total	34	34	33	39	64	50	64	30	36	62	51	74	54	43	38	36	48	40	27	37	37	71	55	37	32	34
	Gross Pur.-Offshore Fund					2														0	0		.8	.2	.2		
	Gross Sales - Total	24	25	23	35	38	35	36	24	28	38	33	43	27	23	20	23	44	29	23	19	20	30	24	25	20	17
	Gross Sales-Offshore Fund					0														.1	5		0	2	0		
	Net Purchases - Total	10	9	10	4	26	15	28	6	8	24	.8	31	27	20	18	13	4	11	4	18	17	41	31	12	12	17
	Net Pur.-Offshore Funds					.2														-.1	-.5		.8	0	.2		
	Fund Activity	1												7												2	
NETHERLANDS	Gross Purchases - Total	34	25	230	30	43	34	28	29	23	47	46	52	45	35	37	29	51	46	53	38	54	136	68	52	64	58
	Gross Pur.-Offshore Fund	.6	.1	2			.8					7			1.5	1.9	2.2	.7	1.3	.4	.1	2.2	1 3	4.0	7	1.7	.2
	Gross Sales - Total	23	14	20	25	29	28	32	23	19	40	28	43	36	33	24	29	29	30	29	53	20	57	47	65	69	52
	Gross Sales-Offshore Funds	0	0	0			.2					.1			0	0	0	.4	0	0	0	0	0	.2	0	2.6	0
	Net Purchases - Total	11	11	210	5	14	6	-4	6	4	7	18	9	9	2	13	--	22	16	24	-15	34	79	21	-13	-5	6
	Net Pur.-Offshore Funds	.6	.1	.2			.6					.6			1.5	1 9	2.2	.3	1.3	.4	.1	2 2	1.3	3.8	7	- 9	.2
	Fund Activity	6												24												5	
SWITZERLAND	Gross Purchases - Total	327	246	245	390	428	429	451	358	371	570	469	576	474	401	332	307	432	297	263	299	298	486	338	292	242	244
	Gross Pur.-Offshore Funds	58.6	63 5	68.1	123.4	119.6	98 4	81.2	39.5	85.7	144.0	79 7	124.3	129.3	103.4	85.9	86.3	174.3	87 5	84.7	131.8	292.5	198.5	91 0	78.9	70.8	74.2
	Gross Sales - Total	262	222	220	270	436	335	332	310	326	451	377	498	324	291	250	273	369	418	326	270	260	360	301	287	266	225
	Gross Sales-Offshore Funds	49.1	52.0	66.7	55.1	114 2	62.6	61.9	44.7	80.3	85.5	42.6	110.8	106.5	76.9	67.3	92.2	105.2	178.1	126.4	127.1	170.2	120.6	95.5	135.5	90.0	105.1
	Net Purchases - Total	65	24	25	120	-8	94	119	48	45	119	92	78	150	110	82	34	63	-121	-63	29	38	126	37	5	-24	19
	Net Pur.-Offshore Funds	9.5	11.5	1.4	68.3	5.4	35.8	19.3	-5.2	5.4	58.5	37.1	13.5	22.8	26.5	-1.4	-5.9	69 1	-90.6	-41.7	4.7	122.3	77.9	-4.5	-56.6	-19.2	30.9
	Fund Activity	224												578												106	

(Table 6A cont'd)

(Table VII-6A cont'd)

Country		1968 Jan	Feb.	Mar.	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	1969 Jan.	Feb.	Mar.	April	May	June	July	Aug.	Sept	Oct.	Nov.	Dec.	1970 Jan.	Feb.
U.K.	Gross Purchases - Total	67	51	46	68	112	70	61	62	65	89	110	93	93	91	65	56	108	85	77	74	68	100	84	86	77	72
	Gross Pur.-Offshore Funds	7.5	20.4	11.4	20.1	22.1	22.5	.7	4.2	1.0	3.9	.3	1.3	.9	.7	.4	.7	1.6	.5	.4	.4	5	1.3	.3	4.2	2.4	1.3
	Gross Sales - Total	73	56	58	61	97	79	70	71	58	101	83	114	92	89	104	77	135	154	108	95	73	134	96	77	73	75
	Gross Sales-Offshore Funds	17.8	3.5	8.2	8.4	9.0	7.3	.4	5.0	8	5 8	0	.1	.2	1.0	.5	.5	.6	.9	.3	1.1	1.0	.3	.4	.9	2.0	2.0
	Net Purchases - Total	-6	-5	-12	7	15	-9	-9	-9	7	-12	27	-21	1	2	-39	-21	-27	-69	-31	-21	-5	-34	-12	9	4	-3
	Net Pur.-Offshore Funds	-10 3	16.9	3.2	11.7	13 1	15.2	.3	-.8	.2	-1.9	3	1 2	.7	-.3	-.1	.2	1.0	-.4	.1	-.7	-.5	1 0	-.1	3.3	.4	-.7
	Fund Activity	69												115												24	
PANAMA	Gross Purchases - Total	5	3	3	7	8	7	6	5	6	7	9	14	8	6	4	5	7	6	4	5	3	6	5	4	5	3
	Gross Pur.-Offshore Funds		.1	.1		1.3	.4			.2	7.0	0	0	0		0		.5	.4	0	.9	0	.8	1.5	.4	1 5	.1
	Gross Sales - Total	6	5	8	6	7	5	5	6	8	14	14	11	7	5	4	5	6	9	4	6	4	5	5	3	5	4
	Gross Sales-Offshore Funds		0	0		0	.2			0	0	0	.3	.2		0		1	.1	.2	0	0	.2	1.0	0	1.2	0
	Net Purchases - Total	-1	-2	-5	1	1	2	1	-1	-2	-7	-5	3	1	1	--	--	1	-3	--	-1	-1	1	--	1	--	-1
	Net Pur.-Offshore Funds		.1	.1		1.3	.2			.2	7.0	0	-.3	- 2		0		.4	.3	-.2	.9	0	.6	.5	.4	.3	.1
	Fund Activity	11												22												6	
(a) BAHAMA and (b) BERMUDA																											
(a & b)	Gross Purchases - Total	42	26	25	59	54	68	55	46	52	87	73	93	103	132	66	87	128	123	113	88	76	105	59	75	76	58
(a) Bahama	Gross Pur -Offshore Funds	28.3	22.9	21.2	52.3	35 5	18.4	39.9	44.2	28.0	39.0	24.4	32.3	38.4	48.4	37.7	47.6	78 8	59.2	80.4	44.4	49.9	79.7	48 6	63 9	52.7	32.1
(b) Bermuda	Gross Pur.-Offshore Funds	11.0	8.4	8.1	15.5	16.6	14.2	14.2	6.3	14.3	23 4	18.4	15.7	16.6	9.8	10.0	15 9	17.5	18.6	11.3	13.3	11.7	22.6	9.4	9 8	14.6	10.8
	Total Offshore	39.3	31 3	29.3	67.8	52.1	32.6	54.1	50.5	42.3	62.4	42.8	48.0	55.0	58 2	47.7	63.5	96.3	77.8	91.7	57 7	61.6	102.3	58.0	73.7	67.3	42.9
(a & b)	Gross Sales - Total	30	28	35	33	40	53	47	42	48	60	63	60	78	92	85	84	100	108	112	110	93	70	62	84	52	65
(a) Bahama	Gross Sales-Offshore Funds	24.0	25.3	26.8	20.1	30.7	27.3	27 5	52 3	25.9	29.3	26.3	26.5	32.0	24.5	41.8	37.4	47.1	60.0	70 9	44.2	65.3	47.6	47 7	59.6	31.1	48.9
(b) Bermuda	Gross Sales-Offshore Funds	12.7	11.3	3.9	13.3	15.1	29.1	16 3	13.5	10.1	9.6	4 6	16 4	11.6	14.2	1.2	14.1	14.8	20.4	13.3	12.1	12.6	12.1	11 4	10.1	15 5	12.9
	Total Offshore Funds	36 7	36.6	30 7	33.4	45.8	56.4	43.8	65.8	36.0	38.9	30.9	42 9	43.6	38.7	43.0	51.5	61.9	80.4	84.2	56.3	77.9	59.7	59 1	69.7	46 6	61.8
(a & b)	Net Purchases - Total	12	-2	-10	26	14	15	8	4	4	27	10	33	25	40	-19	3	28	15	1	-22	-17	35	-3	-9	24	-7
(a) Bahama	Net Pur -Offshore Funds	4.3	-2.4	-5.6	32.2	4.8	-8.9	12.4	-8.1	2.1	9 7	-1.9	5.8	6.4	23 9	-4.1	10.2	31.7	-.8	9.5	.2	-15.4	32 1	.9	4.3	21.6	-16.8
(b) Bermuda	Net Pur.-Offshore Funds	-1.7	-2.9	4.2	2.2	1.5	-14.9	-2.1	-7.2	4.2	13.8	13.8	-.7	5.0	-4 4	8.8	1.8	2.7	-1.8	-2 0	1.2	-.9	10.5	-2.0	-0.3	-.9	-2.1
	Total Offshore Funds	2 6	-5.3	-1.4	34.4	6.3	-23.8	10.3	-15.3	6.3	23.5	11.9	5.1	11.4	19.5	4.7	12.0	34.4	-2 6	7.5	1.4	-16.3	42.6	-1.1	4.0	20.7	-18.9
	Fund Activity	478												1277												271	
NETHERLANDS ANTILLES	Gross Purchases - Total	27	17	22	42	37	33	31	22	22	55	41	55	38	39	45	35	44	27	26	28	26	50	33	34	57	27
	Gross Pur.-Offshore Funds	28.2	15.7	11.7	46.1	31.0	51.0	49.1	33.5	36.8	59.3	50.6	67.9	65.3	81 5	51.7	72.4	99.0	60.6	53.6	79.4	71.3	83.8	72.4	63.5	78.7	59.6
	Gross Sales - Total	25	19	19	34	33	40	37	42	16	40	29	51	36	42	39	29	39	29	23	27	24	33	27	29	58	48
	Gross Sales-Offshore Funds	16.7	12.3	15.4	18.9	27.7	33.0	31.0	31.0	30.2	40.9	46.3	39.8	71.7	68.4	66.5	55.8	76.7	69.8	57.9	64.6	69.0	64.1	62 5	62.2	78.7	59.3
	Net Purchases - Total	2	-2	3	8	4	-7	-6	-20	6	15	12	4	2	-3	6	6	5	-2	3	1	2	17	6	5	-1	-21
	Net Sales-Offshore Funds	11.5	3.4	-3.7	27.2	3.3	18.0	18.1	2.5	6.6	18.4	14.3	28.1	-6.4	13.1	-14.8	16.6	22.3	-9.2	-4.3	14.8	2.3	19.7	9 9	1.3	0	.3
	Fund Activity	977												2479												441	
CANADA	Purchases - Total	190	124	163	225	234	245	221	176	165	225	258	284	261	190	143	163	209	166	115	106	124	206	151	128	101	111
	Gross Purchases-Offshore	2.5	1.3	4.4	8.4	5.9	3.7	4.6	4 6	5.6	5.9	4.3	.9	2.8	1.2	1.8	7.3	23.9	9.0	8.3	7.8	9.2	10.8	5.1	2.4	2.7	3.5
	Gross Sales - Total	142	109	138	159	219	208	176	167	140	204	219	246	167	154	153	154	211	151	108	134	127	174	155	151	139	135
	Gross Sales-Offshore Funds	1.8	.6	3.5	2.8	3.0	2.5	3.3	2.6	1.6	4.4	3.2	1.1	.7	1.6	2.5	.4	2.3	4.9	4.0	3.4	1.4	9.1	5.8	2 4	1.4	3.2
	Net Purchases - Total	48	15	25	66	15	37	45	9	25	21	39	38	94	36	-10	9	-2	15	7	-28	-3	32	-4	-23	-38	-24
	Net Sales-Offshore Funds	.7	.7	.9	5.6	2.9	1.2	1.3	2.0	4.0	1.5	1.1	-.2	2.1	-.4	-.7	6.9	21.6	4.1	4.3	4.4	7.8	1.7	-.7	0	1.3	.3
	Fund Activity	93												208												33	
OTHER	Gross Purchases - Total	99	65	60	105	119	128	86	81	88	107	100	122	100	83	29	88	80	66	60	52	44	80	62	53	38	38
	Gross Pur.-Offshore Funds	.3	1	.5	1.8	1.1	.6	.1	0	.7	.6	0	1.3	.6	1.9	1.7	.8	12.9	4 6	7.0	6.2	4.2	7 0	7.3	14.3	2.2	3.2
	Gross Sales - Total	76	54	59	90	119	112	80	81	70	98	86	120	73	75	49	48	48	56	43	39	43	64	55	43	37	36
	Gross Sales-Offshore Funds	1.3	.9	.1	.2	.1	1.4	.1	.1	.3	.1	.8	3.0	1.5	1.5	4.4	.3	1.6	2.5	1 4	1.5	2.4	5.5	4.8	12.0	1.2	4.1
	Net Purchases - Total	23	11	1	15	--	16	6	--	18	9	14	2	27	8	-20	40	32	10	17	13	1	16	7	10	1	2
	Net Pur.-Offshore Funds	-1 0	-.8	.4	1.6	1.0	-.8	0	-.1	.4	.5	.8	-1.7	-.9	.4	-2.7	5	11.3	2.1	5.6	4.7	1.8	1.5	2.5	2.3	1.0	-.9
	Fund Activity	67												194												36	

(Table 6A cont'd)

(Table VII-6A Cont'd 36/)

Country	1968 Jan	Feb.	Mar.	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
TOTALS												
Gross Pur.-All Foreigners	913	657	914	1,080	1,221	1,161	1,124	891	926	1,376	1,305	1,520
Gross Pur.-Offshore Funds	143.1	143.3	141.5	284.0	252.5	235.8	213.8	142.1	185.3	294.2	196.9	283.1
(Percent)	16	22	15	26	21	20	19	16	20	21	15	19
Gross Sales-All Foreigners	737	581	651	804	1,129	963	899	812	778	1,167	1,023	1,286
Gross Sales-Offshore Funds	133.1	109.6	132.1	133.6	214.4	178 9	153.8	159.0	157 9	188.4	137.0	213.1
(Percent)	18	19	20	17	19	19	17	20	20	16	13	17
Net Pur.- All Foreigners	176	76	263	276	92	198	225	79	148	209	282	234
Net Pur -Offshore Funds	10.0	33.7	9.4	150.4	38.1	56.9	60.0	-16.1	27 4	105.7	59.9	70.0
(Percent)	6	44	4	55	41	29	27	19	19	39	21	30
Fund Activity	2,116											

Country	1969 Jan.	Feb.	Mar.	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	1970 Jan.	Feb.
TOTALS														
Gross Pur.-All Foreigners	1,314	1,165	929	882	1,273	948	824	904	866	1,413	985	870	774	751
Gross Pur.-Offshore Funds	275.2	268.8	204.3	256 0	448.5	259.9	270.5	297.1	458.1	437 0	285.5	263 3	250.6	212.7
(Percent)	21	23	22	29	35	27	33	33	53	31	29	30	32	28
Gross Sales-All Foreigners	957	897	829	808	1,124	1,057	882	818	753	1,069	873	854	816	767
Gross Sales-Offshore Funds	238.6	199.9	212.8	210.3	259.3	348.7	286.6	265.7	337.6	278.9	253.4	300.8	242.5	252.1
(Percent)	25	22	26	26	23	33	33	33	45	26	29	35	30	33
Net Pur.- All Foreigners	357	268	100	74	149	-109	-58	86	113	344	112	16	42	-16
Net Pur -Offshore Funds	36.6	68 9	-8.5	45 7	189.2	-88.8	-16.3	31.4	120 5	158.1	32.1	-37 6	8.1	-39.4
(Percent)	10	26		62	127	81	28	37	107	46	29		19	246
Fund Activity	5,497												1,073	

36/ Data on all foreign purchases and sales are as reported to the Treasury Department. Because of unpublished revisions, there may be some slight variance with data published in the *Treasury Bulletin.*
Data on offshore funds came from material supplied to the Institutional Investory Study.
Figures may not be exactly the same as in Table 5 of this chapter because of statistical rounding.

TABLE VII-6B - Summary Annual Totals (Millions of Dollars)

COUNTRY		CALENDAR YEARS	
Belgium and Luxembourg		1968	1969
	Gross Purchases - Total	338	851
(a) Belgium	Gross Pur.-Offshore Funds	5.7	9.2
(b) Luxembourg	Gross Pur.-Offshore Funds	193.4	270.0
	Total Offshore	199.1	279.2
	Gross Sales - Total	258	627
(a) Belgium	Gross Sales - Offshore Funds	7.7	6.5
(b) Luxembourg	Gross Sales-Offshore Funds	125.8	157.5
	Total Offshore Funds	133.5	164.0
	Net Purchases - Total	80	224
(a) Belgium	Net Pur. -Offshore Funds	-2.0	2.7
(b) Luxembourg	Net Pur.-Offshore Funds	67.6	112.5
	Total Offshore Funds	65.6	115.2
	Fund Activity	180	555
France	Gross Purchases - Total	780	600
	Gross Pur.-Offshore Funds	9.2	10.9
	Gross Sales - Total	578	452
	Gross Sales-Offshore Funds	4.9	3.3
	Net Purchases - Total	202	148
	Net Pur.-Offshore Funds	4.3	7.6
	Fund Activity	10	38
Germany	Gross Purchases - Total	571	523
	Gross Pur.-Offshore Fund	0.2	1.2
	Gross Sales - Total	382	307
	Gross Sales-Offshore	0.0	0.8
	Net Purchases - Total	189	216
	Net Pur.-Offshore Funds	0.2	0.4
	Fund Activity	1	7

TABLE VII-6B Summary Annual Totals (Millions of Dollars)

COUNTRY		CALENDAR YEARS 1968	1969
Netherlands	Gross Pur. -Total	621	644
	Gross Pur.-Offshore Funds	2.4	16.3
	Gross Sales - Total	324	452
	Gross Sales-Offshore Funds	0.3	0.6
	Net Purchases - Total	297	192
	Net Pur.-Offshore Funds	2.1	15.7
	Fund Activity	6	24
Switzerland	Gross Pur. - Total	4860	4219
	Gross Pur.-Offshore Funds	1086.0	1544.1
	Gross Sales - Total	4039	3729
	Gross Sales-Offshore Funds	825.5	1421.5
	Net Purchases - Total	821	490
	Net Pur.-Offshore Funds	260.5	122.6
	Fund Activity	224	578
United Kingdom	Gross Purchases - Total	894	987
	Gross Pur.-Offshore Funds	115.4	11.9
	Gross Sales - Total	921	1234
	Gross Sales-Offshore Funds	66.3	7.7
	Net Purchases - Total	-27	-247
	Net Pur. - Offshore Funds	49.1	4.2
	Fund Activity	69	115

TABLE VII-6B - Summary Annual Totals (Millions of Dollars) - CALENDAR YEAR

Country		1968	1969
Panama	Gross Purchases - Total	80	63
	Gross Pur.-Offshore Funds	9.1	4.5
	Gross Sales - Total	95	63
	Gross Sales-Offshore Funds	0.5	1.8
	Net Purchases - Total	-15	--
	Net Pur.-Offshore Funds	8.6	2.7
	Fund Activity	11	22
	Bahamas & Bermuda		
	Gross Purchases - Total	680	1155
(a) Bahamas	Gross Pur.-Offshore Funds	386.4	677.0
(b) Bermuda	Gross Pur.-Offshore Funds	166.1	166.5
	Total Offshore	552.5	843.5
	Gross Sales - Total	539	1078
(a) Bahamas	Gross Sales-Offshore Funds	342.0	578.1
(b) Bermuda	Gross Sales-Offshore Funds	155.9	147.9
	Total Offshore Funds	497.9	726.0
	Net Purchases - Total	141	77
(a) Bahamas	Net Pur.-Offshore Funds	44.4	98.9
(b) Bermuda	Net Pur.-Offshore Funds	10.2	18.6
	Total Offshore Funds	54.6	117.5
	Fund Activity	478	1277
Netherlands Antilles			
	Gross Purchases - Total	404	425
	Gross Pur.-Offshore Funds	480.9	854.5
	Gross Sales - Total	385	377
	Gross Sales-Offshore Funds	343.2	789.2
	Net Purchases - Total	19	48
	Net Purchases-Offshore Funds	137.7	65.3
	Fund Activity	977	2479

TABLE VII-6B Summary Annual Totals (Millions of Dollars)

COUNTRY		CALENDAR YEARS	
		1968	1969
Canada	Purchases - Total	2510	1962
	Gross Purchases - Offshore	52.1	89.6
	Gross Sales - Total	2127	1839
	Gross Sales - Offshore Funds	30.4	38.5
	Net Purchases - Total	38.3	123
	Net Purchase - Offshore Funds	21.7	51.1
	Fund Activity	93	208
Other	Gross Purchases - Total	1160	797
	Gross Pur. - Offshore Funds	8.7	68.5
	Gross Sales - Total	1045	662
	Gross Sales - Offshore Funds	8.4	39.4
	Net Purchases - Total	115	135
	Net Pur. - Offshore Funds	0.3	29.1
	Fund Activity	67	194
TOTALS			
	Gross Pur. - All Foreigners	13088	12373
	Gross Pur. - Offshore Funds	2515.6	3724.2
	(Percent)	19	30
	Gross Sales - All Foreigners	10830	10921
	Gross Sales - Offshore Funds	1910.9	3192.8
	(Percent)	18	29
	Net Pur. - Total	2258	1452
	Net. Pur. - Offshore Funds	604.7	531.4
	(Percent)	27	36
	Fund Activity	2116	5497

TABLE VII-7

GROSS PURCHASES, SALES AND NET ACQUISITIONS OF COMMON STOCK BY SELECTED INSTITUTIONS
1969

	1 Q	2 Q	3 Q	4 Q	YEAR
1. Private Noninsured Pension Funds					
Purchases	3,695	3,875	3,380	4,280	15,230
Sales	2,375	2,795	2,390	2,710	10,270
Net Purchases	1,320	1,080	985	1,575	4,960
2. Open-end Investment Companies					
Purchases	5,195	6,295	4,985	5,590	22,065
Sales	5,315	5,195	4,640	4,700	19,850
Net Purchases	-125	1,095	345	890	2,205
3. Life Insurance Companies					
Purchases	875	930	725	1,175	3,705
Sales	430	495	575	685	2,185
Net Purchases	445	435	155	485	1,520
4. Property and Casualty Insurance Companies					
Purchases	775	975	940	1,090	3,780
Sales	520	715	880	765	2,880
Net Purchases	250	260	65	325	900
5. Total (1 to 4 above)					
Purchases	10,535	12,070	10,030	12,135	44,770
Sales	8,645	9,200	8,485	8,860	35,190
Net Purchases	1,895	2,870	1,545	3,275	9,585
6. All Foreigners (Reported to the Treasury)					
Purchases	3,408	3,103	2,594	3,268	12,373
Sales	2,683	2,989	2,453	2,796	10,921
Net Purchases	725	114	141	472	1,452
7. Offshore Funds (Reported to the Study)					
Purchases	748	965	1,026	986	3,725
Sales	652	818	891	833	3,194
Net Purchases	96	147	135	153	531

SOURCES: Pension fund and property and casualty insurance companies: SEC; investment companies: Investment Company Institute; life insurance companies: Institute of Life Insurance; foreigners: Treasury Department; offshore funds: Institutional Investor Study, Form J-73.

I. TRENDS AND DEVELOPMENTS

The statistical data collected by the Study (see particularly Tables VII-1A and VII-5A) cover a period from January 1968 to February 1970. This section attempts to briefly highlight developments from February 1970 until midsummer 1970, and to project likely trends.

1. Investment in the U.S. Market

In the first six months of 1970, net foreign sales of U.S. stock totaled $224 million. This disinvestment is not surprising given the continued drop in U.S. common stock prices. This does not imply that the U.S. market has lost all appeal for foreigners. During January–June 1970, when foreigners made gross sales of $4,590 million, they were also purchasing $4,366 million in U.S. stock. Foreigners made net purchases of $508 million in U.S. bonds in the same six months (gross sales of $804 million, gross purchases of $1,311 million).[37]

The January–February 1970 offshore data in Table VII-5 (net bond sales of $4.5 million, net stock sales of $31.3 million) are not really adequate for making even a summary judgment on likely trends in offshore funds' purchases and sales since this period. The fall in U.S. stock prices and the firming of bond yields may have induced some switching in the composition of portfolio holdings. Many funds were reportedly staying liquid in order to meet possible redemptions, to profit from still further market declines, to take advantage of high yielding short-term Euro-dollar placements, or investment alternatives in other national markets.

Many foreign funds trade very actively. They presumably will be back into U.S. stocks when the U.S. market turns around.

During recent years at least, foreign investors have not made heavy redemptions (in terms of the total value of their investments) in the face of a falling U.S. market. Rather, they have tended to ride out the storm, although at times changing the composition of their portfolios.

Some credit for this is probably due to the basic underlying strength of the U.S. economy and relative political stability (viewed against the abrupt manner of political changes in certain other parts of the world). Developments in Europe, that is, the effect of the Russian invasion of Czechoslovakia, the student upheavals in France in 1968–1969, fear of Governments shifting to the left with attendant nationalization of domestic industries, are cited as factors that may have induced capital flows to the U.S.[38] In other words, some foreign portfolio investment, having managed to find its way to the U.S., seems to stay here regardless of market trends.

Offshore funds presumably are less concerned than individual investors with socio-political developments when managing their portfolios. As already noted, the U.S. market remains one of the few where large amounts of cash can be invested without relative market disturbance; thus some portion of new net investment flows to the offshore funds (that is, the excess of sales over redemptions) can logically be expected to continue to be placed in the more attractive investment opportunities in the U.S.

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[37] *Treasury Bulletin*, August, 1970, p. 115.

[38] See, Klopstock, Fred H., "Foreign Demand for U.S. Equities—The Role of Offshore Mutual Funds," Federal Reserve Bank of New York, *Monthly Review*, July, 1970, p. 164.

For example, investment analysts of major European financial institutions reportedly feel much more at home in the U.S. market than they did, say, five years ago. They are frequent visitors to the U.S.—not only in New York, but in other major centers as well. The worldwide growth of branches of U.S. brokerage houses and banks with their attendant increase in correspondent relationships with foreign institutions has had the effect of making the U.S. market better known to many medium sized foreign investment houses and banks which are now taking a more direct interest in U.S. securities.

2. Characteristics of Foreign Investors

The inflow of foreign capital to the U.S., in addition to being a function of U.S. market performance, is also a function of the flow of cash from foreign savers to the foreign financial institutions that actually make the investments. The largest offshore fund complex, Investors Overseas Services (IOS), has suffered a series of setbacks that have reportedly frightened off many small and medium sized investors; it is precsiely these investors who made their previous investments in offshore funds because they had been actively solicited by a direct sales force.

The wealthy, more sophisticated private foreign investor or foreign institution may have placed orders with an offshore fund in order to avoid tax or foreign exchange control problems that might otherwise have been encountered, or because of the experienced portfolio management offered by some of these funds. However, if the offshore funds had not existed, much of this cash would still probably have reached the U.S. securities markets through other channels.

On the other hand, the small and medium size savers who were contacted by direct sales forces represented a new, net addition to the international flow of capital. To the extent that the "IOS debacle" has shaken their confidence and diminished the flow, the contribution of the offshore fund industrv to the U.S. balance of payments and capital market has also suffered.

3. Organizational Trends

The organizers of offshore funds seem to have mastered the intricacies of establishing funds in the legal structures and venues that best suit their purposes. Their current problems seem more those of selling the funds to customers, particularly small and medium sized savers. The Study understands that concerted efforts are being made to improve marketing techniques.

Offshore funds or their parent organizations are reportedly seeking technical assistance from large U.S. mutual fund complexes that have experience with captive sales forces aimed at individual investors. Other observers speculate that financial institutions with many foreign branches and correspondents should be well placed to make sales of offshore fund shares and profit from their future growth.

4. Recent Performance of the Offshore Funds

Because lack of regulation and capital gains tax considerations imply greater investment flexibility, a logical assumption is that the

investment performance of offshore funds should be better than that of onshore or national funds that are subject to these constraints.

The Study has not attempted to measure the overall performance of the offshore funds, in part because much of the relevant portfolio data is not available. There are foreign publications that have begun to report performance of offshore funds. While the Study cannot verify their analysis or the method of valuation of fund assets, at least two recent evaluations have been made.

One of these was by Intervestment Management Limited of London. Its July 1, 1970 analysis [39] reports that the median performance of offshore equity funds for the year 1969 showed a loss of 5.8 percent in net asset value.[40]

Against this median 5.8 loss in 1969, the Dow Jones (DJ) industrial average declined 15.2 percent; the Standard and Poor's 500 stock index (SP 500) declined 11.4 percent. Both the Dow Jones and Standard and Poor's indices are weighted averages, the composition of the Standard and Poor's probably being more relevant to offshore fund portfolio holdings because of its wider range of holdings.

The Intervestment analysis of offshore equity funds' median performance shows a decline in net asset value of 19.6 percent for the 12 months ending June 1970, with the DJ showing a decline of 21.7 percent and the SP 500 a decline of 25.6 percent. For the first six months of 1970, the figures show offshore funds' median average down 17.8 percent; DJ off 14.6 percent; the SP 500 down 21.0 percent.[41]

The Intervestment performance analysis of all types of offshore funds (178 were considered including real estate funds) showed a median decline in net asset value of 5.1 percent for 1969, 18.5 percent for the 12 months ending June 1970, and 15.3 percent for the first six months of 1970. This indicates better performance from the non-equity type of offshore funds (subject of course to the methods used in valuing the assets). Intervestment also presented a single mean average of the performance of all the offshore funds considered, including equity, real estate and other. This showed a decline in net asset value of 2.0 percent in 1969, 18.1 percent in the 12 months ending June 1970, and 15.5 percent for the first six months of 1970.

Another financial publication, the *Economist* (London), recently listed the growth records of 89 equity and real estate offshore funds [42] over 12 months ending in May 1970. The analysis showed nine funds posting gains of from 2.2 percent to 37.7 percent: it showed 14 funds with losses from 1.4 to 12.9 percent; 12 funds with losses from 13.7 to 18.2 percent; 13 funds with losses from 20.4 to 23.3 percent; 13 funds with losses from 23.6 to 33.0 percent; 13 funds with losses from 33.7

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[39] The Intervestment Management Analysis of Offshore Funds, P.O. Box 529, London, SW1. The analysis was compiled under the supervision of Mr. George Pessagno.

[40] Median change means that of the funds considered, half showed a loss greater than 5.8 percent, and half had performance better than 5.8 percent. The figure is not statistically weighted.

[41] The statistical method used for measuring performance between Intervestment offshore equity funds and the SP 500 is not the same, however. *Offshore Funds—1970* (George Pessagno. GPO Box 3140, New York, New York), another publication in this area reports the same figures for offshore fund median performance in 1969 and the first six months of 1970, apparently based on the same analysis published by Intervestment.

[42] "Some winners but many more losers", June 30, 1970, pp. 96, 99, 101. Growth was measured "on an offered price basis and ignoring income."

to 38.8 percent; and 15 funds with losses from 39 to 72.3 percent. The median decline for these funds was 23.1 percent.

The *Economist* concluded:

> "Offshore Funds are a high risk investment precisely because it is difficult to know what their managers are really doing with the funds entrusted to them. As high risk investments they should be expected to show better performance, especially as they can apparently switch their investments between the world's markets and have a juicy Eurodollar money market to help them when equities pale. But achievement has not lived up to promise, perhaps because too many salesmen and not enough investment managers have got into the business." [43]

J. AREAS OF CONCERN

The actions of offshore funds can cause concern both in the U.S. market, through actions affecting U.S. securities and companies, and abroad in connection with sales to foreigners.

The Study did not investigate specific offshore funds, but did try to survey the entire industry and get an impresion of overall activities. Certain practices came to the Study's attention and are set forth here. Some are already well known to Congress.

1. In the U.S. Market

As pointed out in what follows, an offshore fund can commit excesses or wrongdoings. A member of the Commission's staff testified before a House Committee [44] concerned with foreign bank secrecy and bank records. Specific areas of concern cited in connection with offshore funds included take-over attempts financed with foreign funds, market manipulation, and abuse of inside information. Offshore funds can avoid U.S. margin requirements and are in a position to buy U.S. securities subject only to whatever borrowing or margin restraints may be imposed upon them by foreign banks. The fact that an offshore fund can avoid margin requirements and can utilize leverage gives it considerably more speculative potential and market impact than its assets would otherwise suggest.

The Study has been told that for the purchase of good quality securities, some foreign financial institutions and banks are willing to lend (that is, provide margin) up to roughly half the purchase price. Practices would vary from country to country in part reflecting local monetary and credit policies.

Where this form of "margin" is coupled with the use of leverage, that is, money borrowed from other sources to make up a portion of the remainder of the purchase price, the returns can be very high in a rising market; the results can be very poor—even catastrophic—in a falling one as banks call for more margin to protect the value of their loans and the debt servicing burden of other borowing increases as a percentage of the fund's assets and income. However, in terms of the U.S. market as a whole, it appears unlikely that the offshore funds

[43] Id. at 99.

[44] Statement of Irving M. Pollack, Director, Division of Trading and Markets, Securities and Exchange Commission before the Committee on Banking and Currency, House of Representatives, March 2. 1970, in *Foreign Bank Secrecy and Bank Records, Hearings before the Committee on Banking and Currency* House of Representatives, Ninety-first Congress, pp. 175–311.

could exercise a significant influence on overall market trends in relation to the considerably larger impact of the resources and purchasing power of domestic U.S. institutional investors. However, this broad judgement is subject to qualification in terms of specific securities, particularly those that are narrowly held, or where an offshore fund might own a large percentage of a U.S. company. For example, the Congressional testimony already cited [45] reported the case of a small foreign company traded in the over-the-counter market whose stock gyrated wildly, rising from $26 to $54 in two months, and then sank to $22. One offshore fund purchased 30,000 shares during a one-month period at prices ranging from $30 to $36.75. The offshore fund then sold 7,000 shares a month later at prices between $50.50 and $52.50.

Another point of concern could be heavy offshore fund sales of a single U.S. stock or heavy redemptions of U.S. mutual fund shares. The *New York Times* on July 2, 1969 reported that Arnold Bernhard, the controlling person of the investment adviser of Value Line Special Situations Fund had indicated that sometime between April and June, "the fund's biggest holder, the Fund of Funds, 'liquidated its entire position in ten days' and that this caused some difficulty because 'we had to pay them right away . . .' " [46]

In 1969, an offshore fund, Mad International S.A. joined with other investors, including its U.S. affiliate the Madison Fund, in an attempt to gain control of Bath Industries, whose principal business is the construction of destroyers for the U.S. Navy. However, the group failed to file with the Commission a required Schedule 13D report on the attempt to gain control, which was therefore found to be illegal.[47]

There has been at least one occasion in the past when heavy concentrated foreign sales of U.S. securities had a noticeably depressing effect on the NYSE.[48] In this case, foreigners sold very heavily during the first hour of trading. To some extent, given the time differences with Europe (which is five or six hours ahead of the U.S.), it would be normal for orders placed during the business day in Europe to be bunched during the opening hours at the New York Exchange.

The discretionary portfolio authority enjoyed by so many of the offshore funds' U.S. investment advisers would seem to make this a matter of less concern today. Purchases and sales for offshore funds made by these advisers could be spread out over the entire U.S. marketing day rather than concentrated in any particular period.

Another recent case of official U.S. concern with offshore funds in the U.S. market has been that of Investors Overseas Service (IOS). The Commission already has provided the Congress with heavy documentation of IOS' activities; [49] it is not the Study's intention to repeat that documentation in any detail.

In summary, however, the Commission's staff asserted that IOS had sold interests in Fund of Funds within the jurisdiction of the U.S. in

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[45] *Id.*, at p. 178.

[46] *Id.*, at pp. 210–211.

[47] *Id.*, at pp. 305–306. See also *Bath Industries* v. *Blot*. 427 F. 2d 96 (C.A. 7, 1970).

[48] *A Report on Stock Trading on the NYSE on September 3, 1946* by the Trading and Exchange Division of the Securities and Exchange Commission, August 21, 1947, pp. 47–49.

[49] Securities and Exchange Commission Litigation, Investors Overseas Services, in *Foreign Bank Secrecy and Bank Records, Hearings before the Committee on Banking and Currency*, House of Representatives, Ninety-First Congress, December 4, 10, 1969; March 2 and 9, 1970, pp. 198–311.

violation of the registration requirements of both the Securities Act and the Investment Company Act; that the prospectus and sales literature used by IOS to describe Fund of Funds contained statements that fell far short of the disclosure standards of the Securities Act and the Securities Exchange Act; and that IOS caused investment companies registered with the Commission to execute transactions with certain broker-dealers or required give-ups from the registered funds' brokers to broker-dealers designated by IOS.

Other staff charges included alleged violations concerning operations of IOS affiliates with registered investment companies in violation of the Investment Company Act, willful failure to preserve required records, and failure to produce certain records.

These matters date from 1965, and led to the Commission's Order of Settlement with IOS in 1967.[50] Since then additional problems have arisen involving IOS, and the staff has alleged the public sale of unregistered securities, and violations of anti-fraud provisions of the Federal securities laws.

During 1970, IOS has had severe difficulties stemming from loans to insiders, changes in management, unsuccessful takeover attempts, illiquid asset holdings that could not be readily redeemed, and well publicized charges and countercharges by past and current members of management.

To the extent that IOS had to sell portfolio securities in order to raise cash to meet its shareholders' requests for redemptions, there is concern about the impact on U.S. market stability when a fund complex the size of IOS sells off its large holdings of U.S. securities. Is there a significant direct effect on general market stability? Overall, the answer is probably not, given the size and breadth of the U.S. market. On the other hand, the effect on a given security, particularly if narrowly held or with only a small float, could be noticeable.

2. In Foreign Markets

Developments in foreign markets could also have harmful effects on the U.S. market.

In general, bringing individual savers to the market place through professional investment company portfolio management is a constructive element in the development of a capital market. While IOS pioneered in seeking out small and medium-sized savers and introducing them to the international capital market (thereby introducing a new element of competition for the savings dollars in the countries concerned), its recent activities may have caused small and medium-sized savers to withdraw from the investment market, or perhaps, because of the adverse publicity, to refrain from entering it at all.

Hence, the recent difficulties of IOS and another large offshore fund redounds to the detriment of all offshore funds, and perhaps to American fund sales abroad as well.

There are several other specific cases that have come to the Study's attention in the international financial press. They suggest concern for the protection of foreign investors in offshore funds.

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[50] Securities Exchange Act Release No. 8083 (May 23, 1967).

One area cited as a problem (often in connection with real estate funds) is that of objective valuation of assets and liquidity of portfolio assets; how readily can a letter stock or a building or oil or gas acreage be turned into cash if necessary to meet redemptions? This also is related to questions of insider dealing and conflict of interest; how much incentive does a fund management company have to value assets on a conservative basis when it receives a fee based on the size and growth of assets under management?

In a similar vein, when a company affiliated with the management company receives commission income from the negotiated purchase of assets for a fund, how much incentive is there to press for the lowest price? These illustrations are obviously more pertinent for assets (including securities and real estate) for which an auction market does not exist or for which there are not frequent objective quotations.

Questions of this type are currently being asked in Europe concerning offshore funds and are being cited in the financial press.[51]

Other areas of concern are failure of some offshore funds to make full disclosure of important information in the prospectus (as one fund's sales literature not mentioning a 50 percent decline in assets during the previous year),[52] lack of external audits,[53] and false or misleading identification of external auditors, bank custodians [54] and directors.[55]

Some of the advertisements of offshore funds give the impression that there is no risk—"Free of market ups and downs . . . . Your money is invested directly in ships" says one advertisement.[56]

In reply to a reader's compaint about offshore fund advertising, *Fund Guide International* said

> All five of the funds mentioned should be criticized for unclear presentations. In fact, very few international funds or European funds offer in their literature enough detail and explanation to prospective investors. The U.S. funds, with the SEC at their backs, are forced to do a better job.[57]

At least one fund, International Commodity Fund, has been very slow in making redemptions, with subscribers complaining about redemptions taking from four to seven weeks when the prospectus reportedly states redemptions will be made in seven days.[58]

Other funds have had difficulty with redemptions and calculation of net asset value. The United Capital Investment Fund, Ltd., in a letter to investors dated March 23, 1970, said "it is now apparent that errors in the periodic calculations of net asset value occurred from approximately July, 1968 until the suspension of reductions in December, 1969 with the result that the net asset value per share of the fund used for purposes of sales and redemption price computations was greater than its actual value."

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[51] "Some winners but many more losers." *The Economist*, June 30, 1970, pp. 96, 99 and Sickman, Philip "The Offshore Funds are in Dangerous Waters," *Fortune*, August, 1970. pp. 119–121, 158–160.

[52] Sickman, *op. cit.*, p. 119.

[53] *Op cit.*, p. 120.

[54] *Op. cit.*, p. 121.

[55] "Stop Press," *Fund Guide International*, September 1969, p. 8.

[56] For the International Shipping Fund, in *Fund Guide International*, June 25, 1970, p. 25.

[57] "Asking for Answers," *Fund Guide International*, April 25, 1970, p. 23.

[58] "Asking for Answers," *Fund Guide International*, August 25, 1970, pp. 26–27.

The management company, Continental Investment Corporation, has agreed to repay to the fund "any overpayments for advisory services based on incorrect net asset values . . ." and also arranged for restoration to the fund the amount of overpayments on redemptions.

There have been reports that some offshore funds may trade more actively than necessary, churning the portfolio, and in the process generating brokerage commission for affiliated firms and increasing the brokerage cost to fund investors.

Another dangerous element in this for the U.S. is the damage done to investor confidence in all offshore funds (many of them with U.S. connections) with detrimental effects on the U.S. balance of payments and capital market and perhaps to sales of registered U.S. funds abroad. Indeed the International Federation of Stock Exchanges has warned all investors "of the absolute necessity of assuring themselves at least on a number of essential points" when making fund purchases.[59] Moreover, the industry itself has recognized the abuses being committed, and there has been a call for an international self-regulatory body patterned after the United States' Investment Company Institute and the National Association of Securities Dealers.[60]

K. SUMMARY AND CONCLUSIONS

An offshore fund is an investment company incorporated in a foreign country, the shares of which are generally sold to persons who are residents of foreign countries other than the fund's country of domicile. Although offshore fund shares usually are not offered for sale to Americans, they are often organized and managed by Americans and, typically, they invest all or a substantial portion of their portfolios in U.S. equity securities.

Basically, offshore funds are structured in this manner so as to minimize U.S. and foreign income taxes and to secure maximum freedom from regulation, exchange controls and other restraints. Because offshore funds are not registered under the Investment Company Act of 1940 and their shares are not registered under the Securities Act of 1933, their shares may not be publicly offered in the U.S.

Offshore funds have, within the space of five years, become a significant vehicle for foreign investment in U.S. securities. The reported value of offshore fund holdings of U.S. equities held by U.S. custodians alone increased from about $896 million in December 1967 to $2.35 billion in December 1969, before declining slightly to $2.12 billion in February 1970. During the calendar year 1969, net reported purchases of U.S. equities by offshore funds totalled $534 million or about 36 percent of total net foreign purchases for the entire year.

In many respects, this development has been beneficial. Offshore funds have made a contribution to U.S. balance of payments receipts.

Furthermore, although offshore funds do not pay capital gains tax, they have become a source of U.S. income tax revenue by reason of taxes withheld at the source on dividend and interest income paid to

[59] Press Communique of the Federation International des Bourses de Valeurs dated October 16, 1970.

[60] "The Road to Reason," a speech by John C. Bogle, immediate past Chairman of the Board of Governors of the ICI, given before the Second Annual Trans-World Investment Company Seminar, November 16, 1970, Rome, Italy.

them. It is impossible to calculate the amount of such withholding tax on dividends and interest (at a 30% rate, subject to treaty reduction) paid by offshore funds as a group. However, on U.S. securities holdings (bonds and stocks) of about $3 billion, it would have been substantial, even allowing for heavy investment in low-yield stocks. Also, a number of persons in the U.S. have benefited financially from doing business with or for offshore funds, including brokers and bank custodians and transfer agents. To the extent that this has occurred, U.S. income taxes paid by such persons have been higher.

Offshore funds have also produced undeniable benefits outside the U.S. In some cases, sales organizations connected with offshore funds have been able to tap new sources of capital for equity investment in the countries in which they operate. In addition, as successful competitors for savers' and investors' cash, offshore funds have caused foreign financial institutions to re-examine their own attractiveness and responsiveness to the needs of their domestic savers.

At the same time, however, the development of offshore funds as a significant vehicle for foreign investment in U.S. equities has not been without its problems.

By U.S. standards, the quality of disclosure provided to prospective foreign investors in offshore funds has not always been adequate—in some cases it has been very poor and possibly misleading. On occasion sales practices have been hyper-aggressive and sales and management charges have been excessive. Furthermore, there is no standard for providing investors in such funds with reliable, independently audited reports of operations. In addition, generally operating in a minimal regulatory environment, offshore funds offer little reliable protection against possible overreaching by the organizers and operators of such funds.

In reaction, some foreign countries where shares of the funds are sold have enacted legislation designed to regulate—or in some cases eliminate—the activities of offshore funds. In some countries this legislation is specifically designed to encourage the establishment of domestic or so-called "national" funds.

In those countries where the apparent purpose of such legislation is not investor protection but rather protection of the balance of payments or elimination of competing forces from the domestic capital market, the justification for such restrictions is less clear.

Furthermore, whatever the purpose of the legislation, a most undesirable by-product of such foreign restrictions has been the increasing difficulties and expense experienced by those U.S. fund managers who have elected to enter foreign markets by means of the U.S. registered investment companies they manage rather than by the offshore fund vehicle. Foreign administrative or legislative restrictions with respect to offshore funds have in some cases been applied across-the-board to all investment companies foreign to the countries concerned regardless of whether unregistered offshore or U.S. registered. As a consequence, in some foreign countries it has become exceedingly difficult or expensive to secure permission to offer and sell shares of U.S. registered investment companies. Other countries, however, have recognized the value of registration with the Commission.

Many U.S. fund managers have elected to enter foreign markets

through an offshore rather than an existing U.S. registered fund. For those managers this too is not without problems—even where foreign restrictions present no insurmountable barriers.

Managers of U.S. registered investment companies are fiduciaries. Management of offshore funds, however, tends to subject those fiduciaries to heightened conflicts of interest. For example, while every manager of more than one portfolio is presented with the difficult problem of allocation of portfolio decisions, the problem can be considerably aggravated where the manager also advises an offshore fund from which he may realize a fee for a maximization of portfolio performance substantially higher than that paid by the U.S. registered company. As explained in section G.1.a. of this chapter, the Investment Company Amendments Act of 1970 attempts to deal with this problem.

Still another problem presented by offshore funds lies in their possible impact both on the market for particular U.S. securities and on the market place itself. The activity of offshore funds in particular securities could have a significant impact on the market for particularly volatile securities.

In another area, available data indicates that certain types of offshore funds have experienced an extremely high velocity of portfolio turnover when compared to the portfolio turnover rates of other investment vehicles, including even other offshore funds. While many funds have not been subjected to such trading, the potential is present in all offshore funds due to the absence of limiting regulation and the absence of any capital gains tax or limit comparable to that provided by sub-chapter M of the Internal Revenue Code with respect to U.S. regulated investment companies.

The development of offshore funds as a significant investment vehicle in U.S. equities raises other potential difficulties. Such companies may be utilized as a means of acquiring control over specific U.S. companies contrary to existing laws or otherwise detrimental to U.S. national interests. For example, one offshore fund was alleged in October, 1970 to hold approximately 28 percent of the stock of a U.S. company subject to the Shipping Act of 1916 which limits foreign ownership in such companies to a maximum of 25 percent.[61]

Another difficult question presented by the proliferation of offshore funds arises from the way their management companies are sometimes structured. In some cases, the fund is managed by an offshore management company in part or wholly-owned by the U.S. promoters of the fund. The offshore management company contracts with a domestic investment advisory corporation for portfolio management. Fees retained by the offshore management company and not paid to the domestic adviser for advice present an issue as to whether such fees are or should be subject to U.S. income taxes.[62]

Recently, several offshore funds have suffered financial reversals. In some part, this may be attributable to the fact that the management of these funds engaged in business conduct and financial transactions which would be prohibited if they were subject to the Investment Company Act.

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[61] *Wall Street Journal,* Oct. 1, 1970, at 29 (east. ed.).

[62] In this connection, it should be noted that the 1964 Report of the Presidential Task Force (Fowler Report) stressed even then that "no tax concessions to U.S. corporations or individuals are recommended."

For example, many if not most of the recently disclosed self-dealing transactions engaged in by the management of one large offshore mutual fund complex would be unlawful if the investment companies were registered under the Investment Company Act. In another recent instance, a real estate investment trust which sold redeemable securities encountered liquidity problems, and has had to stop sales and redemptions. If the company had been organized and operated from the United States, this could not have happened because the Federal securities laws would prohibit such a trust from selling securities under the representation that they were fully redeemable at net asset value at the option of the holder. It is somewhat ironic that the managements and promoters of these offshore funds would not sell to Americans because they believed that it was advantageous to avoid registration and regulation by the Commission under the Federal securities laws.

While these experiences may not have significantly affected foreign investor confidence in the U.S. securities markets, they are commonly regarded as having caused a general loss of confidence by foreign investors in offshore mutual funds. By implication this loss of confidence may have been extended to all foreign funds, including perhaps even U.S. registered investment companies sales abroad.

As a consequence, to the extent foreign sales of U.S. funds have been adversely affected, the U.S. balance of payments and capital market may have been denied a positive cash flow. (The same statement is applicable with respect to any country in which investments might otherwise have been made.) Furthermore, to the extent that the recent, well-publicized difficulties of offshore funds have engendered net redemptions by shareholders and have led to the net sale of U.S. securities by the funds, the U.S. is detrimentally affected by an outflow of foreign capital in the balance of payments and by selling pressure on individual securities.

The Study experienced considerable difficulties in gathering data to evaluate the impact of offshore funds on U.S. securities markets and to assess their methods of operation. Putting aside completely the question of the identity of the investors, there is no ready source of such basic data as the total value of offshore fund holdings, their portfolio composition or turnover. Similarly, there is no information available as to their methods of doing business and the degree of self-dealing by insiders.

For the Study, a special questionnaire had to be devised and extensive cooperation solicited from the U.S. securities industry. This did not always yield results because principal books, records, prospectuses and portfolio data are generally kept outside the U.S. Nor can the Commission always seek information abroad without opening itself to criticism for supposed unwarranted extension of sovereignty and conflicts of jurisdiction with laws of other countries.

With respect to the U.S. tax laws, in order to attract foreign investment in U.S. securities, the Foreign Investors Tax Act of 1966 provided certain tax advantages to exempt foreign investors. Offshore funds, like other foreign investors, are exempt from the U.S. capital gains tax. As already noted, this can affect the degree of trading activity.

Offshore funds can also diversify their portfolios beyond U.S. se-

curities by purchasing foreign securities without payment of the interest equalization tax ("IET"). The exemption from the IET for such funds exists so long as they are able to avoid becoming classified as a U.S. person under the terms of the Internal Revenue Code. In contrast, a U.S. domiciled mutual fund (considered to be a U.S. person), is required to pay the IET if it purchases foreign securities for its portfolio and is subject to the constraints on such investments under the Voluntary Foreign Credit Restraint Program administered by the Federal Reserve System.

The Foreign Investors Tax Act also provided estate tax relief to foreign investors. It reduced the estate tax with respect to those foreign investors who directly acquire U.S. securities. However, a foreign person who invests directly in an offshore fund is not subject to U.S. estate tax because he does not invest directly in U.S. securities. He also avoids costs of probate. Thus, a U.S. domiciled, registered, mutual fund is at somewhat of a disadvantage in directly seeking business of foreign private investors. Even those wealthy foreign investors who apparently prefer to purchase funds registered with the Commission because of the regulatory protections afforded, are now encouraged to do so only through foreign financial intermediaries so as to eliminate the estate tax problem.

Recognizing this disadvantage of the registered U.S. funds, in order to gain or recapture this business, many members of the U.S. financial industry who might otherwise have operated more directly with U.S. registered funds, have set up offshore funds to attract and service foreign clients. Of course, the greater investment flexibility and possibility of higher fees and profits in an atmosphere of minimum regulation may have also played a role.

The Foreign Investors Tax Act of 1966 was designed to implement the recommendations of the Fowler Task Force appointed by President Kennedy to develop programs to encourage foreign purchases of U.S. securities. Toward this end, perhaps the most significant change in the Internal Revenue Code made by the FITA (at least with respect to offshore funds), was the provision for the operation of a discretionary trading account by a U.S. agent for foreign investors without subjecting the foreign investors to graduated U.S. income taxes or U.S. capital gains taxes. This change in the Internal Revenue Code helped foster the growth in the number of offshore funds as a vehicle for foreign participation in the U.S. securities markets. Conceivably, such participation would continue to occur if foreign investor interest in the U.S. securities markets is appropriately stimulated and, in addition to the exemption from capital gains tax, U.S. estate taxes on the estates of foreign investors continue to be minimized.

What this suggests is the consideration of various means of encouraging foreign investment directly in shares of U.S. registered investment companies. This is the simplest and most direct approach to increasing foreign investor interest in U.S. securities through the investment company vehicle. Furthermore, foreign investor participation through existing regulated investment company channels would not present the very difficult problem of the added conflict of interest which is inherent in every case of an offshore fund managed by an investment adviser who also manages other investment vehicles which, unlike the offshore fund, are subject to Commission regulation.

It is conceivable that registered investment companies, regardless of the methods considered to enhance their attractiveness to foreign investors, will not be deemed to be an adequate substitute for separate investment companies designed expressly for, and sold exclusively to, foreign investors. To date, such vehicles have been molded into the form of offshore funds.

From the investor's point of view, however, it is clear that the offshore fund, and its propensity for minimal regulation, has not been the ideal vehicle for participation in the U.S. securities markets. The Study has also found that from the point of view of the investment adviser and the promoters of such vehicles, offshore funds have not been without their difficulties. These often include delays in communication, language difficulties, the uncertain quality of foreign audits, high fees charged by oligopolistic service industries in some offshore domiciles, questions of political stability, and the level of competence of foreign staff personnel. As a consequence, some investment advisers connected with offshore funds have expressed an interest in coming back "on shore" if this could be accomplished without sacrificing the benefits enjoyed by their foreign shareholders—that is, if foreign investors in such funds could continue to enjoy the existing benefits of the Foreign Investors Tax Act, including exemption from capital gains tax as well as freedom from U.S. estate tax, and perhaps also anonymity and bearer certificates where desired.

The Need for Accepted International Standards

The rapid recent growth of offshore funds demonstrates an increasing awareness on the part of foreign investors throughout the world of the merits of equity-based investment. In an area of growing internationalization of capital movements and the emergence of transnational business corporations, this awareness and desire for equity investment is not restrained by national boundaries.

As a general proposition, this development should be favorably looked upon by the countries affected. Movements of capital between countries should not be restricted unnecessarily. Accordingly, national regulatory agencies should endeavor to show flexibility in their treatment of foreign funds selling in their markets, provided that the degree of investor protection afforded by the country of origin is generally comparable to that given by their own. Requirements for investor protection should serve to facilitate, rather than impede, the free flow of capital between countries.

To aid the development of such a flexible approach, it would be desirable for most major countries to agree on a minimum norm that could be used as a model or guide, although each country would have the right to impose more restrictive, but non-discriminatory requirements if it wished.

Work at trying to identify common elements in national regulations is under way at the Organization for Economic Cooperation and Development in Paris in the Working Group on Standard Rules for the Operations of Institutions for Collective Investment. Representatives of the Commission and the Treasury Department make up the U.S. delegation to meetings of this group.

While it appears appropriate for the Commission to examine the applicability of Section 7(d) of the Investment Company Act to off-

shore funds which use the U.S. mail or other means or instrumentalities of interstate commerce in connection with the offer or sale of their shares, a system of international uniform standards for investor protection might serve to facilitate the administration of that section. This approach presupposes far greater contact between the Commission and other national regulatory agencies than has been the case to date.

Appendix A

Hedge Funds

Excerpt from the Offering Circular of the Harbor Isle Corporation N. V.; Sagamore Capital Corporation N. V.; March 24, 1969, p. 3.

"The purpose and objective of the fund is to achieve capital appreciation for investors who are neither citizens nor residents of the U.S. Current income will not be a primary objective of the fund.

"To achieve its objective, the fund will utilize the leveraged hedge fund concept. Leveraging consists of borrowing money against securities or buying and/or selling puts and calls in order to increase the appreciation potential of the fund. Such leveraging commensurately increases the risks involved. Hedging consists of selling securities short in order to provide some protection against unanticipated declines in market prices. Short selling may also provide a means of achieving capital appreciation in a declining market, but may limit capital appreciation of the fund in a rising market.

"The leverage of borrowed money, when used, will permit the fund to invest substantially more than 100 percent of its net asset value. Short selling, when used, may result in the fund having a negative net invested position from time to time.

"In pursuing its investment objective, the fund will conform to certain rules set forth below.

"The tax status of the fund will enable it to take advantage of short-term profit opportunities which because of U.S. tax considerations would not normally be sought by most U.S. investors including U.S. mutual funds. These short-term transactions may increase the portfolio turnover rate and lead to higher expenses (including brokerage commissions) than are incurred by most U.S. mutual funds.

SHAREHOLDER PROTECTION

"The fund has adopted certain investment restrictions which are for the protection of its shareholders.

The fund shall not:

(1) engage in underwriting securities issued by others or participate with others in any trading account in securities:

(2) invest for the purpose of exercising control over or management of any company;

(3) invest in the shares of other hedge or mutual funds; or

(4) purchase securities of any issuer (except obligations of the government of the U.S. and obligations of U.S. instrumentalities) if as a result of such purchase the fund would thereupon hold more than 10 percent of the voting securities of such issuer or 20 percent of the total net assets of the fund taken at cost would be invested in the securities of any one issuer.

Such restrictions may be amended or rescinded by a general meeting of shareholders."

Appendix B

FUNDS THAT INVEST IN HEDGE FUNDS

Explanatory Memorandum, Haussmann Holdings. N. V., dated May 12, 1969.

"The objective of the fund is to achieve capital appreciation, rather than current return, in both rising and falling markets.

"To achieve its objective, the fund has adopted a policy of investing in other funds which invest primarily in securities of companies incorporated in the U.S. and which utilize leveraging and hedging principles in making such investments ('hedge funds'). These hedge funds will be chosen primarily on the basis of the

fund's judgment of the ability of their investment managers. By spreading its investment over several other funds, the fund minimizes the financial risk of its investors while making available to them the investment capabilities of several investment managers.

"On subscriptions subsequent to the initial offering on May 30, 1969, there will be no commission or other charge payable to the fund on subscriptions to its shares, which will result in 100 percent of a subscription being invested directly in the various hedge funds in which the fund has invested, with no added cost to the investor. In addition, all reallowances, finder's fees, distributions and other incentive payments received from sponsors of hedge funds in which the fund shall have invested will be placed in the fund for the benefit of all its shareholders.

"The fund has entered into a contract with a repurchase company, according to which investors in the fund will be able to sell their shares in the fund, twice a year, at their net asset value, to such company. The repurchase company will charge one percent commission on all purchases by it of the fund shares."

APPENDIX C

A FUND WITH HEDGE FUND CHARACTERISTICS

Excerpt from prospectus dated November 20, 1969 of the Neuwirth International Fund, N. V., p. 3.

"The principal objective of the Fund is attainment of maximum capital appreciation through investment in common stock and other securities convertible into common stock of United States companies. Particular attention will be given to the equity securities of companies oriented toward expansion and growth. Though investments will be primarily in securities traded in established public markets, capital appreciation may also be sought through investment in special situations, such as securities and private companies (see Objective and Investment Policies—Investment Restrictions). Since growth-oriented companies generally reinvest their income, the Fund may ignore potential dividend or interest income as a criterion in the selection of portfolio securities.

"Although investment techniques such as leveraging and short selling will be employed in an effort to maximize gain in a rising market and to minimize loss in a falling market, portfolio selection will be determined by consideration of various fundamental principles, such as an estimate of the potential growth of the companies and industries in which it is proposed to invest, evaluation of general market conditions, and evaluation of specific market conditions for securities of the particular industry or company. The Fund will also engage in arbitrage transactions, the purchasing and writing of put and call contracts, and similar transactions.

"Investment Restrictions.—Fund investments are subject to certain restrictions which cannot be removed or amended without shareholder consent. The more important of these restrictions provide that the Fund may not:

(1) Purchase securities (other than those of wholly owned subsidiaries) for the purpose of acquiring control of the issuing corporations;

(2) Purchase or sell real estate;

(3) Invest more than 15% of its assets in securities the immediate sale of which is restricted by reason of United States securities laws ('Restricted Securities');

(4) invest more than 10% of its assets in private companies."

APPENDIX D

BANK AFFILIATED FUND

Excerpt from prospectus of the First National City Fund, dated December 16, 1968, p. 4.

"The policy of the Fund is designed to achieve long-term appreciation of the Shareholder's investment. In order to attain this objective the Fund will primarily invest in growth equities. Consequently, the Management Company will select individual securities for the Fund's portfolio according to various criteria, the most important ones of which are quality of management, leadership within the industry, a clear growth trend within the company and in-

dustry, effective research capability, sales and service orientation and the ability to compete in domestic and foreign markets.

"At the present time, the Management Company intends to invest primarily in equities or convertible securities issued or guaranteed by United States corporations or their majority-owned subsidiaries and that, in general, such securities will account for at least 75% of the investments of the Fund with the remainder of the portfolio being invested in equities of non-U.S. issuers. Depending on economic or market conditions, the Fund may invest from time to time in corporate bonds or notes and securities of public authorities.

INVESTMENT AND OTHER RESTRICTIONS

"The investments of the Fund will be subject to the following restrictions for the protection of Shareholders:

(1) Only securities regularly traded on a stock exchange or in other recognized securities markets may be purchased but not more than 20% of the assets of the Fund, calculated at market value on the day of purchase, may be invested in securities which are not listed on a stock exchange.

(2) Not more than 7½% of the assets of the Fund, calculated at market value on the day of purchase, may be invested in securities of any one enterprise.

(3) The assets of the Fund may not be invested in securities entitled to more than 5% of the votes of any one enterprise.

(4) Securities issued by enterprises in existence for less than five years, taking into account, where applicable, the existence of their predecessors or parent companies, may not exceed 10% of the assets of the Fund, calculated at market value on the day of purchase.

(5) Securities not fully paid up shall not represent more than 10% of the assets of the Fund, calculated at market value on the day of purchase, and the aggregate amount subject to call may not exceed 5% of the assets of the Fund on such day.

(6) The assets of the Fund may not be invested in securities of any mutual fund.

(7) The assets of the Fund may not be pledged or hypothecated.

(8) The acquisition of investments by the Fund may not be financed by borrowing.

"The Management Company does not intend to engage in short sales of securities for the account of the Fund.

"The Swiss Federal Investment Fund Act empowers the Swiss National Bank, in the event of serious disturbances in the money and capital market and after consultation with the Swiss Federal Council (the chief executive body of Switzerland), to prohibit for a fixed period the purchase of non-Swiss securities by the Fund."

APPENDIX E

A CONSORTIUM FUND

SEPRO, Save and Prosperity Fund, S.A., Prospectus, 19th November, 1969, p. 3.

SEPRO offers the management and expertise to take advantage of opportunities in the main stock markets of the world; its objective is capital growth through investment in equity shares. No priority will be given to the generation of income, and there is no intention at present to pay dividends.

"Investment Policy.—The Articles of Incorporation of SEPRO contain no investment restrictions and the Advisory Company (see following section) intends to achieve the stated objective through an active investment policy. It will not, however, make a practice of trading for short-term profit in the belief that there are many international investors who are reluctant to accept the volatility of more speculative funds for more than a small part of their investment programme.

"SEPRO will not sell securities short and borrowing will be limited to 10 per cent of net assets for temporary purposes alone, such as to cover different settlement dates in different markets. Nor more than 5 per cent of its assets will be invested in the share capital or bonds of any one company or corporation but this restriction does not apply to Government or public authority

issues; SEPRO will not hold more than 5 per cent of the issued share capital of any one company or corporation with the exception of the Repurchase Company.

"It is proposed that the geographical spread of the portfolio should cover North America, Europe, Japan and the Sterling Area. It is the present intention to invest up to 55 per cent of the assets in the U.S.A. and Canada, 30 per cent in Europe, approximately 10 per cent in Japan and 5 per cent in the Sterling Area (including Australia and South Africa).

"SEPRO will retain complete discretion to vary these percentages and the geographical spread as and when it considers that it would be advantageous to do so.

APPENDIX F

A REGISTERED FUND

"Prospectus, SoGen International Fund, Inc., dated April 28, 1970, pp. 3, 5–6.

"The Fund proposes to sell its shares to United States and foreign investors through SoGen International Corporation. Foreign sales are expected to be made principally in Europe. In addition, it is proposed that persons who are not citizens, residents or nationals of the United States may, if they wish, purchase Bearer Depositary Receipts ('BDR's') representing registered shares of the Fund. The BDR's will be issued by Société Luxembourgeoise de Conversion S. A. (the 'Depositary'), a Luxembourg subsidiary of SoGen International Corporation. Through this marketing arrangement, which will be employed principally in Europe, it is possible that the Depositary will hold a substantial amount of the issued and outstanding capital stock of the Fund. The Depositary has agreed with the Fund to seek and follow instructions from the holders of the BDR's with regard to voting of all Fund shares held by it and to vote any Fund shares for which no such instructions are received in the same proportion as the vote of all shareholders of the Fund who do vote their shares.[63]

"*Foreign Currency Transactions.*—In an attempt to protect an investment in an issuer incorporated or operating in a foreign country or in a security denominated in the currency of a foreign country against a devaluation of that country's currency, the Fund may make arrangements with banks to sell such currency forward. That is, to hedge against a devaluation of a foreign currency, the Fund may enter into a forward market contract to sell to banks a set amount of such currency at a fixed price and at a fixed time in the future. If, in foreign currency transactions, the foreign currency sold forward by the Fund is devalued below the price of the forward market contract and more than any devaluation of the United States dollar during the period of the contract, the Fund will realize a gain as a result of the currency transaction. In this way, the Fund might reduce the impact of any decline in the market value of its foreign investments attributable to devaluation of foreign currencies. The Fund may sell foreign currency forward only as means of protecting its foreign investments and may not otherwise trade in the currencies of foreign countries. Accordingly, the Fund may not sell forward the currency of a particular country to an extent greater than the aggregate market value (at the time of making such sale) of the securities held in its portfolio denominated in that particular foreign currency or issued by companies incorporated or operating in that particular foreign country."

APPENDIX G

OFFSHORE FUNDS THAT INVEST DIRECTLY IN THE SHARES OF DOMESTIC MUTUAL FUNDS

Keystone of America, Limited sponsors an offshore fund, Keystone Funds of America, Limited, (the "Company") incorporated in the Bahamas.

"The cost to the Company of the shares of Keystone Growth Fund K–2 in which it invests will be the net asset value of such shares at the time of investment, as the Company will pay no acquisition charge.

"The value of any shares of the Company owned by a Planholder who is neither a resident nor a national of the United States of America or any of its territories or its possessions or of Puerto Rico at the time of his death will not be subject to United States Federal Estate Taxes.

[63] In addition to providing anonymity, the BDR arrangement will permit foreign purchasers to benefit from offshore treatment in terms of avoidance of U.S. estate taxes.

"The Sponsor will not charge a management fee so long as the Company invests its assets in Keystone Growth Fund K-2.

"It is anticipated that the value of a share of the Company will always equal the value of a share of Keystone Growth Fund K-2. Accordingly, Planholders may ascertain sales and redemption prices for their shares of the Company by referring to the quotations for Keystone Growth Fund K-2 printed daily in The Wall Street Journal, the Financial Post and other leading international newspapers.

"The Plans are not being and will not be offered for sale in the United States of America and plan applications will not knowingly be accepted from persons who are residents or nationals of the United States of America, its territories or its possessions or of Puerto Rico or from any resident of any of the Scheduled Territories of the Sterling Area who is subject to non-sterling investment restrictions. In the event that a Planholder or any person succeeding to his interest in such a Plan is or becomes such national or resident, the Sponsor may cause any such Plan to be terminated and the shares to be redeemed at the redemption value then in effect." [64]

APPENDIX H

OFFSHORE FUNDS ASSOCIATED WITH DOMESTIC MUTUAL FUND MANAGERS

(a) *Fidelity Internal Fund, N.V.*[65]

"The investment objective of the Fund is to seek maximum capital appreciation of its portfolio by investing in securities of companies that are believed to have the greatest possibility for increase in their value. Since the Fund is not restricted by any capital gains tax considerations it may make short-term investments if its Investment Manager believes them to be in the Fund's interest.

"It is anticipated that under normal conditions investments will consist principally of common stocks of United States companies and companies from other parts of the industrialized world. However, the Fund has no restriction on the nationality of securities it may invest in, nor is there any limitation as to industry or country concentration of the Fund's investments.

"A policy of the Fund is to reinvest realized capital gains and not to distribute them.

"While the Fund has broad investment powers to borrow money, to purchase securities on margin, to sell securities short, to purchase commodities, to purchase debt securities, and to trade in puts and calls, the primary intent of the Investment Manager is to invest in marketable stocks without employing these investment methods."

"Investment Restrictions.—While there are no investment restrictions imposed upon the Fund by its Articles of Incorporation, the Board of Directors of the Fund has adopted certain policies designed to assist the Fund in achieving its investment objectives. For these purposes, the Fund will not:

"(1) Purchase securities of any other investment company or investment trust, except in connection with merger or consolidation with, or acquisition of the assets of any such company or trust;

"(2) Purchase securities of any issuer for the purpose of exercising control or management of that issuer;

"(3) Buy or sell any real estate."

(b) *Standard and Poor's International Fund S.A.*[66]

"Investment Objectives and Policies.—The principal objective of the Fund is capital appreciation. In achieving this objective primary emphasis will be given to common stocks of corporations in the United States, although investments may be made in companies in other parts of the world and in securities other than common stock.

"The Fund's investment policies are based on the belief that the desired capital appreciation will, in the long run, be best achieved if the Fund at all times maintains maximum flexibility with respect to the commitment of its assets. Ac-

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[64] Keystone Funds of America, Limited, Prospectus 1967–1968, p. 1.

[65] Fidelity International Fund, N.V., Explanatory Memorandum, 18 February 1969, pp. 2–3.

[66] Prospectus dated October 29, 1969, pp. 4–5.

cordingly, the Fund ordinarily intends to invest the major portion of its assets in readily marketable securities, i.e., stocks of issues of substantial size which are traded actively on the New York Stock Exchange or, in certain circumstances, on other markets which are considered to provide adequate liquidity. The concentration of its holdings in such readily marketable securities will enable the Fund to implement an aggressive investment philosophy under changing conditions and, as a rule, to acquire and dispose of substantial holdings without delay. This flexibility will permit the Fund to invest a significant portion of its assets in a relatively small number of issues which appear to have superior potential for appreciation. Should it appear desirable, the Fund may invest in government, municipal or corporate bonds, commercial paper or similar securities, or retain its assets in cash or the equivalent.

"Subject to the safeguards described below, the Fund may also from time to time use the specialized investment techniques of leveraging and short selling.

"Leveraging involves the use of borrowed money (secured by the Fund's assets) to purchase additional securities. Short selling involves the sale of borrowed shares when the seller expects to be able to replace the borrowed shares by purchasing an equal number of shares of the same issue after an anticipated price decline. However, should the borrowed shares increase in price, the short seller would incur a loss in replacing them. The use of the foregoing techniques will tend to result in greater risks to Shareholders than would otherwise be the case, and the performance of the Fund will consequently depend more on the skills of the Portfolio Manager and the Advisor.

"Investment Safeguards.—Although the Fund's Articles of Incorporation contain no provisions concerning investment objectives and policies, the Shareholders at their meeting on October 3, 1969 adopted the following limitations and safeguards, under which the Fund will not:

"(1) invest in real estate, leases or mortgages;

"(2) invest in commodities or commodity contracts;

"(3) underwrite securities of other companies;

"(4) invest in restricted securities if as a result of such investment more than 15 percent of the consolidated net assets of the Fund (calculated at the time of the investment) would be invested in restricted securities (restricted securities are securities which are subject to legislative or contractual restrictions on resale; their valuation is more fully described under "Determination of Net Asset Value");

"(5) purchase securities of mutual funds or investment companies the assets of which consist substantially of securities of U.S. issuers;

"(6) invest in the securities of other mutual funds or investment companies if as a result of such investment more than 10 percent of the consolidated net assets of the Fund (calculated at the time of the investment) would be invested in such securities; or

"(7) borrow from third parties if as a result of such borrowing the aggregate borrowings from third parties would exceed 50 percent of the consolidated net assets of the Fund.

"In addition, the Board has determined that all securities borrowed for the purpose of a short sale will normally remain secured with cash or U.S. government securities by at least the amount of the proceeds of their sale. Also, if the market price of the borrowed security increases above this amount, additional cash or U.S. government securities will be added to the collateral so that the collateral will always be at least equal to the market value of the borrowed security. Furthermore, not more than 25 percent of the consolidated net assets of the Fund will be used as collateral for short sales of securities, and not more than one-fifth of such 25 percent may be used as collateral for short sales of unlisted securities.

"The Board has also determined that subsidiaries of the Fund will be subject to the same investment limitations and safeguards so that the percentages referred to above shall apply to the Fund and its subsidiaries as a whole.

"Whenever any investment restriction specifies a maximum percentage of the consolidated net assets of the Fund, the Fund shall not be obligated to reduce any holding or borrowing as a result of subsequent market fluctuation, merger or other external event."

(c) A_ merican Express International Fund[67]

"Policies.—The Fund's basic investment objective is growth of Capital. To achieve its objective, the Fund maintains a flexible policy regarding the relative investment merit of the U.S. stock market and various other stock markets, and the Fund will vary its degree of concentration in these markets depending on conditions. Furthermore, the Fund will consider the full spectrum of investment alternatives offered by each market.

"The Fund aggressively uses a modern investment approach appropriate for the responsible management of money. However, the Fund does not sell short (hedge) or use debt (leverage).

"In pursuing its objective of growth of capital, the Fund emphasizes investments with the potential for significantly increased value over a period of time, as contrasted with investments that might yield profits from short-term price fluctuations.

"At the same time, the Fund is alert to rapid change, and seeks to adjust its activities to trends and developments disclosed by continuous research and investigation.

"Opportunities.—The Fund commands a wide range of investment opportunities, and selects those best suited to attain its investment objective. The Fund selects primarily those investments made available through its intimate daily contact with American securities markets and also draws on the extensive international contacts of the widespread American Express organization. It invests predominantly in common stocks and other equities of American companies but is not restricted thereto if other investment forms offer better capital-growth opportunities. Dividend income or interest payments are not directly sought, but may occur as an incidental result of investments made for capital growth."

"Regulations.—To protect the interests of its investors, the Fund operates at all times within the Management Regulations which specify certain limitations, including the following:

"1. The Fund must diversify its holdings so that its value does not depend excessively on single investments; therefore, the Fund will not invest more than 10% of its total assets in securities issued by any one company.

"2. The Fund may not acquire more than 10% of the securities of any one class issued by any one company.

"3. The Fund may not acquire an interest in other investment funds.

"4. The Fund may not acquire title to real property.

"5. The Fund may not invest more than 10% of its total assets at any time in shares that are not listed on a stock exchange, traded in the regular New York over-the-counter market, or for which quotations are not regularly and currently published, other than shares for which listing is announced in an issuing prospectus and which are acquired not later than one year after issue.

"6. The Fund may not hold more than 15% of its assets in cash (other than cash to be distributed as dividends to Shareholders).

"7. The Fund may not purchase shares of, or grant loans to, American Express Company or any company directly or indirectly owned or controlled by American Express Company.

"8. The Fund may not pledge or hypothecate any assets of the Fund and may not finance the acquisition of investments by borrowing.

"9. The Fund may not effect short sales.

The Fund is permitted to purchase securities which are subject to certain restrictions based on contractual agreements provided that such purchase does not conflict with the above limitations."

APPENDIX I

FUNDS OF FUNDS

Investors Overseas Services, Prospectus dated September 24, 1969, pp. 16–17.

"FOF is designed to provide long-term growth of capital. Separate portfolios of securities are managed by sub-advisors most of whom are largely compensated on the basis of their comparative performances. The Fund's assets are principally invested in securities of United States and Canadian companies. Pursuant to an agreement effective January 1, 1968, FOF Management Com-

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[67] Prospectus dated September 30, 1969, pp. 3–5.

pany Limited ("FOF Management"), a wholly-owned subsidiary of IOS Management, manages FOF for 1/24th of 1% per month (½ of 1% per annum) of the monthly average net assets of the Fund. The agreement will expire unless annually renewed by a resolution passed by a majority of the votes cast at a meeting of the holders of the outstanding voting shares of the Fund. IOS Management is the holder of 65%, and IOS is the holder of 35%, of the voting shares of FOF.

* * * * * * *

"At June 30, 1969 approximately 89% of the net assets of FOF was invested in F.O.F. Proprietary Funds Ltd. ("FOF Prop"), its wholly-owned investment company subsidiary, 5% in United States mutual funds and the remainder in cash or its equivalent. FOF Prop is a non-resident Canadian corporation formed on October 16, 1962 and presently consists of 20 proprietary fund accounts. At June 30, 1969, the total net assets in such accounts were $599,520,000. Approximately 1% was invested in commodities and commodity contracts, 2% in real estate (now represented by shares of IPI) and 5% in natural resources. The Company receives a fee of 1% of each investment by FOF in FOF Prop. The Company also acts as portfolio advisor for each account. Pursuant to separate investment advisory agreements with FOF Prop, the Company is entitled to receive investment advisory fees on a calendar quarter basis equal to (i) 10% of the net realized and unrealized securities gains on the investments maintained in the particular proprietary fund account, plus (ii) 10% of the interest, dividends, and other income (excluding income generated from stock loan transactions) earned in respect of said account, less (iii) 10% of the expenses (other than taxes in the case of one account) attributable to the operation of said account. In the event that there is a net realized and unrealized securities loss for such account, such loss is carried forward for the next seven calendar quarters and no advisory fees on securities gains are paid until the lost carried forward has been offset by subsequent securities gains. At present loss carry forwards exist.

"The Company has appointed sub-advisors to render investment advice for 14 of the 20 proprietary fund accounts. Out of the Company's fees, the sub-advisors receive a yearly performance fee on the basis of outperforming FOF or, in some cases, the New York Stock Exchange Composite Common Stock Index. In certain cases, they also receive minimum fixed fees based on average net value of managed assets or specified cash amounts. Subject to minimum fee arrangements, the fees received by the sub-advisors generally cannot exceed 50% of the fees received by the Company from FOF Prop in respect of the particular accounts the sub-advisors respectively advise.

* * * * * * *

"In addition, beginning in 1967, FOF Prop developed a procedure whereby its portfolio securities were made available for loan to member firms of recognized stock exchanges. This service permits such firms to cover deliveries for customers who have sold securities but have not presented them for delivery by the settlement date and to lend securities to customers making short sales. Each loan was collateralized by a deposit of cash equal to the market value of the securities loaned at the time of the loan, adjusted from time to time to conform to market changes. Gross interest income amounting to $2,847,000 was earned through December 31, 1968 by FOF Prop from short-term investment of the cash collateral. FOF Prop paid the Company $645,000 for advice and recommendations in connection with stock loan activities. By agreement dated January 1, 1969, FOF Prop made its portfolio securities available to Financial Institutions Management N.V. ("FIM"), a wholly-owned subsidiary of the Company, so that FIM might conduct a stock loan business for its own account on the same basis as previously conducted. As compensation for the above, FIM has agreed to pay FOF Prop a yearly fee equal to the greater of (i) 4.05 percent per annum of the average outstanding value of FOF Prop securities loaned by FIM, computed on a beginning and end of month basis. For the six month period ended June 30, 1969, FIM earned $1,458,000 in net interest income from lending FOF Prop securities, of which a net amount of $860,000 was accrued for fees payable to FOF Prop.

APPENDIX J

SUMMARY OF THE FOREIGN INVESTORS TAX ACT OF 1966[68]

OLD TAX LAW	NEW TAX LAW
Estate Tax (Applicable Only to Individuals)	
$2,000 exemption.	$30,000 exemption.
Tax return required if U.S. estate exceeded $2,000.	Tax return required if U.S. estate exceeds $30,000.
Graduated tax for estates between $5,000 and $10,000,000. Maximum of 77% on estates over $10,000,000.	Graduated tax for estates between $100,000 and $2,000,000. Maximum of 25% on estates over $2,000,000.

The following table compares the effective rate of the U.S. estate tax on the gross U.S. estates of non-residents before and after the enactment of the Foreign Investors Tax Act of 1966. All computations in this table assume a 10% deduction from the nonresident's gross U.S. estate referred to in the first column, for funeral and other administrative expenses.

[In percent]

U.S. Estate	Old law	New law
$100,000	17.3	3.0
$500,000	26	7.4
$1,000,000	29	10.1
$5,000,000	43	17.8

OLD TAX LAW	NEW TAX LAW
Capital Gains Tax	
Tax was due on all gains during the year if individual was physically present in U.S. for 90 or more days in a taxable year.	Tax is due only if individual is physically present in a taxable year. Gains during a stay of less than 183 days are exempt.
Tax was due on all gains which were realized while individual was physically present in U.S.	No tax due simply because individual is physically present in U.S. when gain is realized.
Tax was due on gains if investor (individual or corporate) also engaged in U.S. business activities unrelated to U.S. securities transactions.	No tax due on securities gains merely because the investor (individual or corporate) is engaged in U.S. business activities not related to securities transactions.
Discretionary Authority to Trade Securities	
If such authority was given to a U.S. agent, investor could be subject to graduated U.S. income tax and U.S. capital gains tax.	Such authority given to a U.S. agent does not subject investor to graduated U.S. income tax or U.S. capital gains tax.
Gift Taxes	
Gifts of U.S. stocks and bonds were subject to gift tax if investor was engaged in business in the U.S.	Gifts of U.S. stocks and bonds are not subject to gift tax.
Income Tax	
Graduated upward beginning at 30% for all income over $21,200 per year (15% for EEC countries.)[69]	Flat 30% on all investment income. (15% for EEC and certain other countries.)[69]
Tax return required for income over $21,200.	No tax return required regardless of size of non-business-related securities income.

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[68] Taken from *A Better Climate for Investing in United States Securities*, the New York Stock Exchange, December 1967, pp. 16–17.

[69] For many countries with which the United States has tax treaties, the income tax withheld and owed on dividend, interest and similar investment income is less than 30 percent.

Withheld taxes did not always cover investor's tax liability; some tax was usually owed in addition to tax withheld at source, necessitating filing of U.S. income tax return.	Full tax liability withheld at source. Investor owes no additional taxes on investment income and is not required to file a return.
U.S. securities income of an individual investing through a non-U.S. corporation was, in some instances, subject to a personal holding company tax.	U.S. securities income of a non-resident individual investing through a non-U.S. corporation generally is not subject to a personal holding company tax.

APPENDIX K

TAX CONSEQUENCES TO UNITED STATES SHAREHOLDERS IN OFFSHORE FUNDS

This section elaborates on the technical aspects of the provisions of the Internal Revenue Code that U.S. shareholders in offshore funds would seek to avoid.

(i) Foreign Personal Holding Company Provisions

The foreign personal holding company provisions of the Internal Revenue Code are contained in sections 551–558. Unlike the domestic personal holding company provisions (sections 541–547), which impose a penalty tax on the undistributed personal holding company income of the corporations, the foreign personal holding company provisions require the undistributed foreign personal holding company income of a foreign personal holding company to be included as a dividend in the gross income of United States shareholders of the foreign personal holding company.

Pursuant to section 551(b) of the Code, the undistributed foreign personal holding company income of a foreign personal holding company is included only in the gross income of United States shareholders who were shareholders in the foreign personal holding company on the last day of its taxable year on which a "United States group" existed with respect to the company. The term "United States group" is defined in section 552(a)(2) and refers to the stock ownership requirement (which is one of the two statutory requirements for foreign personal holding company status) that at any time during the taxable year more than 50 percent in value of the foreign corporation's stock is owned, directly or indirectly by or for not more than five individuals who are citizens or residents of the United States.

Section 552 of the Code provides generally that a foreign personal holding company is any foreign corporation, other than a corporation exempt from taxation under Subchapter F of the Code and certain banking institutions, which for the taxable year meets both (1) the statutory stock ownership requirement referred to above and (2) the statutory gross income requirement specified in section 552(a)(1).

To meet the gross income requirement, at least 60 percent of the gross income of a foreign corporation for the taxable year must be foreign personal holding company income as defined in section 553. However, if a foreign corporation is a foreign personal holding company for one taxable year, the minimum percentage for subsequent taxable years is 50 percent until (1) a taxable year during the whole of which the stock ownership test is not satisfied or (2) the expiration of 3 consecutive years in each of which less than 50 percent of the gross income is foreign personal holding company income.

Section 553(a)(2) of the Code provides that except in the case of regular dealers, gains from the sale or exchange of stock and securities constitute foreign personal holding company income. Since 1954, however, only the excess of gains over losses from such transactions is taken into account in computing gross income. Section 1.543-1(b)(5)(ii) of the regulations provides that the term "regular dealer in stock or securities" means a corporation with an established place of business regularly engaged in the purchase of stock and securities and their resale to customers. However, such corporations are not considered as regular dealers with respect to stock or securities which are held for investment. Dividends from stock or securities are also generally included within the definition of foreign personal holding company income pursuant to section 553(a)(1).

From the foregoing, it would appear that offshore funds and foreign invest-

ment companies would meet the gross income requirement of section 552(a)(1) of the Code since the gross income of such corporations would consist primarily of foreign personal holding company income. In this connection, section 555(a) provides that, for purposes of the foreign personal holding company provisions, the gross income of a foreign corporation is computed in the same manner as if the foreign corporation were a domestic corporation which is a personal holding company. Thus, the gross income of a potential foreign personal holding company includes income from all sources, whether within or without the United States, which is not specifically excluded from gross income under other provisions of the Code.

Although an offshore fund would likely meet the statutory gross income requirement for foreign personal holding company status, it is doubtful that it would meet the stock ownership requirement unless more than 50 percent in value of its outstanding stock could be attributed to five or fewer United States citizens or residents. In this connection, section 554 of the Code sets forth 4 general rules of constructive ownership applicable in determining if the stock ownership requirement has been met:

(1) Constructive ownership by reason of indirect ownership, that is, through corporations, partnerships, estates and trusts in which citizens or residents of the United States have an interest;

(2) Constructive ownership by reason of ownership by members of a citizen or resident's family or by his partner;

(3) Constructive ownership by reasons of ownership of options; and

(4) Constructive ownership by reason of convertible securities.

As a final comment, it should be noted that if a foreign corporation is classified as a foreign personal holding company, it is not subject to either the accumulated earnings tax imposed by section 531 (Code section 532(b)(2)) or the personal holding company tax imposed by section 541 (Code section 542(c)(5)).

(ii) Controlled Foreign Corporation Provisions

Broadly stated, the general rule of the controlled foreign corporation provisions (sections 951–964) of the Code is that United States shareholders who own or are considered to own 10 percent or more of the total combined voting power of a foreign corporation, the voting stock of which is owned more than 50 percent by such United States shareholders, must include in gross income their pro rata share of certain tainted income of the foreign corporation.

The most important category of tainted income under the controlled corporation provision is "Subpart F" income. However, section 951(a)(1) of the Code also requires United States shareholders (as defined in section 951(b)) to include in gross income (1) their pro rata share of the corporation's previously excluded subpart F income withdrawn from investment in less developed countries, and (2) their pro rata share of the corporation's increase in earnings invested in United States property.

The controlled foreign corporation provisions are similar to the foreign personal holding company provisions in that they both require United States shareholders to include in gross income the income of certain foreign corporations in which they own, directly or indirectly, controlling share interests. However, section 951(d) prevents a United States shareholder from being subject to both sets of provisions during the same taxable year by providing that a United States shareholder who for his taxable year is subject to the foreign personal holding company tax on income of a controlled foreign corporation shall not also be subject to the tax otherwise imposed on United States shareholders of controlled foreign corporations.

One of the components of Subpart F income is "Foreign Personal Holding Company Income" which is defined in section 954(c) of the Code. Generally, dividends and other income or gains from the sale of stock and securities constitute tainted income under both the controlled foreign corporation and foreign personal holding company provision. However, section 954(c)(3)(B) specifically excludes from this category of tainted income dividends, interest, and gains from the sale or exchange of stock or securities derived in the conduct of a banking, financing, or similar business.

Section 952(b) of the Code provides that subpart F income does not include any item of income from sources within the United States which is effectively connected with the conduct by such corporation of a trade or business within the United States unless such item is exempt from tax (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the United States.

It would not appear that this exclusion would benefit a United States shareholder of an offshore fund which otherwise would qualify as a controlled foreign corporation since the United States sourced income of an offshore fund which did not have its principal office in the United States would not, pursuant to section 864(b) (2) (A) (ii), constitute effectively connected income.

(iii) Foreign Repatriated Earnings—Section 1248—Sale or Exchange Treatment

Section 1248 was added to the Code by the Revenue Act of 1962 and was intended to complement the controlled foreign corporation provisions. Prior to the enactment of section 1248, earnings from abroad of a controlled foreign corporation could be repatriated at capital gains rates through a sale or exchange of the stock or the liquidation of the corporation itself. The basic objective of section 1248 is taxation of such foreign repatriated earnings at ordinary income tax rates.

To accomplish this objective section 1248 generally provides that the gain recognized on the sale or exchange of such stock by shareholders described in section 1248(a)(2) shall be included in such shareholder's gross income, as a dividend, to the extent of the earnings and profits of the foreign corporation attributable to such stock which were accumulated in taxable years of such foreign corporation beginning after December 31, 1962, and during the period or periods the stock sold or exchanged was held by such person while such foreign corporation was a controlled foreign corporation.

The income tax treatment prescribed by section 1248 governs any shareholder who is a United States person (as defined in section 7701(a)(30)) who owned 10 percent or more of the total combined voting power of the stock of a foreign corporation at any time during the 5 year period ending on the date of the sale of exchange, providing the corporation was a controlled foreign corporation at any time the stock was owned by the shareholder. Section 1248 applies to any sale or exchange or to any surrender of stock for redemption in a transaction which would be treated as a sale or exchange under section 302 or as a liquidation under section 331.

(iv) Gain on Foreign Investment Company Stock

Section 1246, which was added to the Code by the Revenue Act of 1962, provides, in effect, for ordinary income treatment for sales or exchanges of stock of foreign investment companies. The general rule is stated in section 1246(a)(1) which provides, in part, that in the case of a sale or exchange after December 31, 1962, of stock in a foreign corporation which was a foreign investment company at any time during the period in which such taxpayer held such stock, any gain shall be treated as gain from the sale or exchange of property which is not a captial asset, to the extent of the taxpayer's ratable share of the earnings and profits of such corporation accumulated for taxable years beginning after December 31, 1962. Excluded from such earnings and profits are amounts previously included in gross income under section 951, pertaining to subpart F income.

Section 1246(b) of the Code defines a foreign investment company, in part, as any foreign corporation (1) which is registered under the Investment Company Act of 1940 as amended (15 U.S.C. 80a-1 to 80b-2), either as a management company or a unit investment trust, or (2) engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities at a time when more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or of the total value of shares of all classes of stock was held directly or indirectly (within the meaning of section 958(a)), by United States persons (as defined in section 7701(a)(30)).

Section 1247 of the Code provides, in effect, that section 1246 shall not apply to qualified shareholders (as defined in section 1247(c)) of a foreign investment company, which is registered under the Investment Company Act of 1940 if such company among other requirements, elects on or before December 13, 1962, with respect to each taxable year beginning after December 31, 1962, to distribute to its shareholders 90 percent or more of what its taxable income would be if it were a domestic corporation and to designate in a written notice mailed to its shareholders at any time before the expiration of 45 days after the close of its taxable year the pro rata amount of the excess (determined as if such corporation were a domestic corporation) of the net long term capital gain over the net short term capital loss of the taxable year, and the portion thereof which is being distributed.

The application of section 1246 to United States shareholders of offshore funds depends primarily upon whether such fund is a foreign investment company as defined in section 1246(b). Even if the fund does come within the category of a foreign investment company, however, United States shareholders of certain offshore funds may avoid section 1246 treatment if the fund is eligible for and makes the election prescribed in section 1247.

(*v*) *Accumulated Earnings Tax*

Section 531(a) of the Code imposes the accumulated earnings tax on the accumulated taxable income of every corporation[70] formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation by permitting earnings and profits to accumulate instead of being divided or distributed. The tax is equal to the sum of 27½ percent of the accumulated taxable income (as defined in section 535) which is not in excess of $100,000 and 38½ percent of the accumulated taxable income in excess of $100,000.

Section 1.532–1(c) of the regulations provides that section 531 is applicable to any foreign corporation, whether resident or nonresident, with respect to any income derived from sources within the United States, if any of its shareholders are subject to income tax on the distributions of the corporation by reason of being (1) citizens or residents of the United States, or (2) nonresident alien individuals to whom section 871 is applicable, or (3) foreign corporations if a beneficial interest therein is owned directly or indirectly by any shareholder specified in (1) or (2).

Although a detailed analysis of the accumulated earnings tax provisions is beyond the scope of this appendix, it should be noted that section 533(b) of the Code provides that the fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders.

In this regard, section 1.533–1(c) of the regulations provides that a corporation having practically no activities except holding property and collecting income therefrom or investing therein shall be considered a holding company within the meaning of section 533(c).

If the activities further include, or consist substantially of buying or selling stock, securities, real estate, or other investment property (whether upon an outright or marginal basis) so that the income is derived not only from the investment yield but also from profits upon market fluctuations, the corporation shall be considered an investment company within the meaning of section 533(b) of the Code.

Due to the complimentary nature of section 2483 and the controlled foreign corporation provisions, the observations made in connection with the latter provisions with respect to their applicability to offshore funds are also relevant to section 2483.

Thus, generally speaking, a United States shareholder of an offshore fund will not be subject to the income tax treatment prescribed by section 1248 unless the fund is a controlled foreign corporation and unless such shareholder owns, directly or indirectly, 10 percent or more of the total combined voting power of such fund. In this connection, section 1248(a)(2) of the Code indicates that the constructive ownership rules of section 958(b) are to be used in determining if the 10 percent stock ownership requirements have been met.

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[70] Other than a personal holding company as defined in section 542; a foreign personal holding company as defined in section 552; or a corporation exempt from tax under subchapter F.

CHAPTER VIII

PENSION-BENEFIT PLANS, FOUNDATIONS AND EDUCATIONAL ENDOWMENTS

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APPENDIX A

Sample Selection and Questionnaire Design

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CHAPTER VIII

PENSION-BENEFIT PLANS, FOUNDATIONS AND EDUCATIONAL ENDOWMENTS

A. OVERVIEW

The purpose of this chapter is to present the findings of a series of studies of the major groups of institutional portfolios. These portfolio groups include corporate and multiemployer pension-benefit plans, public retirement systems, foundations and educational endowments. Together with individuals and other institutional portfolios these portfolios constitute the "buyers" of a commodity—the investment advice and management services "sold" by institutional investment managers such as banks having trust departments, investment advisory firms and insurance companies. Another shared characteristic of this group of portfolios is that they all are, or have the opportunity to be, exempt from income taxation under the Internal Revenue Code. This characteristic becomes important because once it is assured that tax-exempt status is protected, these portfolios' expectations regarding investment activity and return are not subject to the distorting influences of either the personal or the corporate tax. This is not to imply that tax constraints do not exist, they do and will be discussed in some detail later in this chapter; but on the whole their influence is preliminary and specific rather than pervasive and general.

The decision to study these portfolio types directly was made in the belief that a complete understanding of the role of institutional managers would depend not only on inquiry into their characteristics but also upon the characteristics of their major institutional clients. Often, it is difficult to determine whether the activities of a manager are traceable solely to its decisions, or whether these activities reflect the decisions of the clients of a manager. This is particularly the case when the client is a large institution such as a pension plan or endowment. Thus, the focus of this chapter is on the client, the object of competition, whereas the focus of the preceeding chapters was on the type of institution providing the service, the competitor.

To the extent that these portfolio types are managed internally, they resemble institutional investment managers, and for these, the Study gathered much of the same data on organization for investment management and practice as was gathered for the institutional managers. These data will permit the fairly direct comparison on a number of key points of self management as an option in the quest for asset management with such external options as banks, investment advisers and insurers.

In previous chapters the Study looked to these portfolios as types of accounts managed by the type of institutional manager with which the chapter dealt. The concerns there were structure of the industry and the firm, and the processes by which the firms made investment

decisions. In this chapter, however, the Study will look to the structure of the portfolio type in question, the legal and regulatory framework within which it exists and the investment incentives of those who make the decisions as to where and by whom the portfolio's assets will be managed. Basic economic data regarding size and composition of the portfolios and recent changes will be examined, as will fees and expenses incurred and common stock turnover and activity rates.

In approaching this study of institutional portfolios, a two-tiered process of sample design and data collection was undertaken. The specifics of the questionnairing process is set forth in detail in an appendix to this chapter. In general, however, the process consisted of (1) determining that portion of each group of portfolios which contained the largest of each group in terms of total assets, (2) sending a preliminary or screening questionnaire to each member of these groups, (3) selecting a subset of institutions from the groups on the basis of responses to the preliminary questionnaires and (4) sending a final, detailed questionnaire to each member of the subset. The final questionnaire package contained a number of forms designed to provide responses which could be compared readily across institutional types on such matters as portfolio composition, fees and expenses, and turnover and activity rates. Other questions sought information of a nature more particular to each type of institution. All of these questionnaires have been reproduced largely as they were sent out in Supplementary Volume II to which reference will from time-to-time be made. Where necessary, details from the questionnaires will be given as data are presented.

B. LEGAL, REGULATORY AND TAX ENVIRONMENT OF PENSION-BENEFIT PLANS AND PUBLIC RETIREMENT SYSTEMS

At least a cursory awareness of the major elements of the legal, regulatory and tax environment of retirement funds generally is a necessary partner to an understanding of their actions as institutional clients, and to an understanding of their managers as institutional investors. In the case of pension-benefit plans, the predominant elements in the legal picture are the Internal Revenue Code, the federal Pension and Welfare Plans Disclosure Act, the securities laws, and local law relative to trusts, fiduciary responsibility and, for insured plans, local insurance laws. Multiemployer plans with a joint union-employer board of trustees will generally be concerned with the provisions of the federal labor laws, primarily the Taft-Hartley Act, as well as the above, while state and local government retirement systems will be affected fundamentally by local statutes establishing and governing the systems.

Before looking at the legal backdrop it will be useful first to become attuned to the basic theme and structure of corporate pension-benefit plans and the variations on the theme which exists among them.

1. Corporate Pension-Benefit Plans

For definitional purposes the Study adopted the definition of pension-benefit plan contained in the Federal Pension and Welfare Plans Disclosure Act:

> [A]ny plan, fund, or program which is communicated or its benefits described in writing to the employees, and which was heretofore or is hereafter established by an employer or by an employee organization, or by both, for the purpose of pro-

viding for its participants or their beneficiaries, by the purchase of insurance or annuity contracts or otherwise, retirement benefits, and includes any profit-sharing plan which provides benefits at or after retirement. 29 U.S.C. § 302.

While the greatest number of plans which are studied in this chapter are pension plans, some are profit-sharing plans and it will be useful to be aware of the characteristics which distinguish them.

a. Pension plans

The basic concept of a pension plan consists of an employer promising to each employee who meets certain qualifying criteria income following the employee's termination of employment by reason of retirement.[1] The amount of such benefit is based most usually on the amount

[1] The legal literature is replete with discussion of the precise nature of the employer's obligation to individual employees upon the establishment of a plan. These questions are usually raised when for one reason or another the plan terminates with insufficient funds to provide the expected benefits. For a good general discussion of the problems see M. Bernstein, *The Future of Private Pensions*, ch. V (1964), see also Levin, *Proposals to Eliminate Inequitable Loss of Pension Benefits*, 15 Vill. L. Rev. 527 (1970). As a general rule, subject to all the usual infirmities of generalities, it can be said that: "The pension plan is a unilateral contract which creates a vested right in those employees who accept the offer it contains by continuing in employment for the requisite number of years. . . . Such an employee receives only a right to receive a monthly pension, not in a specified amount, but an amount computed in accord with the provisions and conditions of the whole contract." Hurd v. Illinois Bell Telephone Co., 234 F.2d 942, 946 (7th Cir. 1956), *affirming*, 136 F. Supp. 125 (D.C.N.D. Ill. 1955).

Most large current plans contain language which has the effect of limiting the employer's liability to money in the fund or trust and provisions permitting the employer to terminate or modify the plan at its discretion. The following examples are from plans among the Study's I–8 sample.

"The Company will pay the entire cost of the Plan by making contributions to an irrevocable trust fund to be held by a corporate trustee. All pensions under the Plan will be paid from this trust fund. The Company intends to make the contributions necessary to meet the cost of the Plan but such contributions shall be voluntary and the Company does not guarantee either the making of the contributions or the benefits under the Plan. Such Company contributions will be determined on the basis of annual actuarial valuations of the contingent assets and liabilities of the Plan by a qualified actuary designated by the Retirement Committee."

* * * * * * *

"Section 9. Certain Rights and Obligations of the Corporation

(1) It is the intention that the Plan continue and that contributions be made regularly each year, but all contributions to the Plan shall be voluntary and not a legal obligation."

* * * * * * *

11. *General*

The adoption and maintenance of the Plan shall not be deemed to constitute a contract with any employee, nor shall the adoption and maintenance of the Plan be consideration for, an inducement to, or a condition of, the employment of any employee. No Employer shall have any liability to provide pensions or other benefits under the Plan except as expressly provided herein, and no employee, unless and until his retirement or other termination of employment occurs while the Plan is in full force and effect and under conditions of eligibility for pension, shall have any right to a pension under the Plan. No Employee, Pensioner or other person shall have or acquire any right, title or interest under any contract between the Company and any insurance company except such right, title and interest as he may acquire in annuity purchased for him under said contract. Employment rights shall not be enlarged or affected by reason of any provision of the Plan.

* * * * * * *

"ARTICLE V. AMENDMENT OR TERMINATION

The Company reserves to itself the right to alter, amend, modify, revoke or terminate this Plan, and/or any trust or insurance contract that may be established by it to effectuate and implement this Plan. The Company further reserves the right to determine the time and manner of the payment of contributions to any such fund. Notwithstanding the foregoing, no part of the retirement fund shall be used for or diverted to purposes other than for the exclusive benefit of the Employees of the Company or their beneficiaries. After satisfaction of all liabilities of the Plan, such contributions as may have been made by the Company as the result of overpayments may revert to the Company."

* * * * * * *

"CONCERNING THE COMPANY

Section 1. Rights Against the Company. Neither the establishment of the Fund nor the Agreement covering the Fund, nor any modification thereof, nor the payment of any benefits thereunder, shall be construed as giving to any Participant or any person whomsoever any legal or equitable rights against the Company or its officers or directors, as such, except as expressly granted to them, as provided herein, or as giving any employee or Participant the right to be retained in the service of the Company."

of time the employee has spent in the employ of the employer and on the rate of compensation he has been receiving. For example, a plan may provide for the payment during each month of retirement of one percent of the employee's average monthly salary during his five years' employment at his highest salary level for each year of service with the employer. Under such a plan an employee who had worked 35 years, achieving his own highest salary level of $600 per month, would receive 35 percent of $600 per month or $210 per month during his retirement. The plan may specify that if the employee dies within ten years (or some other specified period) after retiring that the amount will continue to be paid to his beneficiary for the remainder of the period. The essence of the plan then is the present creation of a future liability on the part of the employer to pay money to the employee. An employer might choose to meet this obligation simply by paying out each year to retired employees from the general resources of the employer the amount obligated. This type of plan is generally known as a pay-as-you-go plan or an "unfunded" plan. In the more typical case, influenced no doubt by the tax benefits to be described later, the employer sets money aside each year to "fund" these liabilities.

The funding of a plan is typically done in one of two ways. By purchasing annuity contracts (fixed or variable or both) from an insurance company writing annuity contracts,[2] or by establishing a trust which will receive contributions and invest them in securities or other assets and invest and reinvest the proceeds of such investments, ultimately supplying the dollars needed to pay off accrued and matured liabilities to employees. Some plans may provide both through a trust and an insurance company (split-funded plans). Some plans (contributory plans) may permit (or require) an employee to contribute to the retirement fund during the course of his employment in order to augment the amount of benefit he will receive during retirement.

In the typical trusteed plan, the employer engages the services of an actuary to assist in determining the amount of the employer's annual contribution. This amount will be determined on the basis of assumptions as to employee turnover, death, rates of pay, and the rate of return to be realized by the investments of the fund, among others. In the insured plans, similar actuarial calculations will have gone into establishing the price of an annuity. A distinction should be made between past and current service liabilities. At the time a plan is initiated, the employer will frequently determine to grant retirement benefits based on a formula which will take into account service prior to the date of establishment of the plan. Liabilities arising out of these benefits, in contrast to liabilities arising out of service during the operation of the plan, are referred to as past service liabilities. Past service liabilities may also be created if, during the operation of the plan, the level of benefits to be received at retirement is increased for periods of service prior to the initiation of the new benefit level. For purposes of funding, a distinction is generally made between past and current service costs. Current service costs are in general funded each year in an amount actuarially calculated to be adequate to pay

[2] Section 1-401(g) of the Internal Revenue Code of 1954 defines "annuity" to include a face-amount certificate as defined by sec. 2(a)(15) of the Investment Company Act of 1940 if certain conditions as to transferability are met.

future benefits. Past service costs are in general funded gradually over a period of years with only the interest on the unfunded amounts paid in currently.

In the case of trusteed plans, the trustee is normally a bank having trust powers, although there is no obligation that a bank be the trustee. Even in such cases, however, there is no requirement that the trustee be given unlimited or sole discretion with respect to the investments of the funds. In many cases advice may be purchased from an investment adviser and although the bank is trustee the adviser will be the effective manager of the assets. In some cases the employer itself may retain the authority to select investments.

Thus, the money for a pension plan may come either from the employer alone (noncontributory plan) or from both the employer and the employees (contributory plan), and it may be funded either as an insured plan—where life insurance or annuity contracts are purchased—or as a trusteed plan—where a bank or some other trustee or more than one trustee is selected. Within the latter category, of course, management may be in the hands of the trustee, or of an outside investment adviser or remain in the hands of the employer. The benefits provided under the plan may be fixed dollar benefits as in the example above, or they may be variable in an effort to hedge against the effects of long-term inflation on fixed dollar guarantees and to permit participation in anticipated long-term economic growth. Variability when it occurs may be based on the investment return of the trust, or of a segregated asset account in the case of plans managed by an insurance company, or may be based on escalator clauses relating to some outside index such as the cost-of-living index.

One other aspect of pension plans should be discussed—the concept of vested benefits. In general, a covered employee may be said to have vested benefits when he becomes entitled to receive a benefit at retirement age whether or not he continues in the employ of the employer until he reaches that age. Many large plans now provide for some kind of vesting prior to retirement.[3] One large company's plan provides:

> An eligible employee (i.e., 40 years of age and 15 years' service) who leaves the business for any reason except retirement on pension on or after June 1, 1969 has a "vested" right to a deferred service pension. At age 65 upon application there will be payable the monthly amount equal to 1% for each year of employment of the employees average monthly rate of pay for his highest paid 5 consecutive years of employment before termination. The minimum pension provisions do not apply nor do the provisions for death benefits or annuitants' pensions.

This formula is similar to the plan's rate previously set forth as an example. Another large company describes its vesting provisions as follows:

> ELIGIBILITY.—If your employment is terminated after you are 40 but before you are 65, and if you have at least 10 years of continuous service, but are not eligible for any other pension under this plan except a deferred vested pension for a prior period of continuous service, you become eligible for a deferred vested pension.
>
> AMOUNT.—If proper application is made, your pension will become payable during the month following the month in which you became 65. Your deferred

[3] See Table VIII–12, below, for the results of a Study question on vesting.

vested pension monthly payment will be equal to $5.50 multiplied by the number of years of your continuous service at the time your employment was terminated.

Some plans will provide for a graduated, deferred, vested benefit, so that the vested amount will be an increasing amount depending upon the number of years of employment. In some plans, provision for early retirement will permit an employee to retire prior to the normal age for retirement and still receive a pension, usually at a somewhat reduced rate.

Largely because of requirements of the tax code and the Federal Disclosure Act, the large majority of pension plans are embodied in a written document called the "Plan." This plan describes the nature of the benefits to be paid, whether employee contributions can be made and if so according to what schedules, and also sets forth whether and how provision is made for death benefits, vested rights, and such other matters as how application for benefits are to be made, what group has the power to resolve controversy, etc. In many cases provisions of a plan are arrived at in collective bargaining between a union and the employer and the terms of the plan may also be embodied in the collective-bargaining contract.

In the case of trusteed plans another important plan document will be the Trust Agreement between the employer and (in most cases) the corporate trustee (a bank). The trust agreement generally will, *inter alia*, spell out the authority of the trustee with respect to investments. In the Study's sample of corporate plans, few trustees reported being significantly restricted in their investment authority by the trust instrument. Many stated that the trust instrument specifically gave them authority to make investments which would not otherwise be appropriate for a trustee under the local law of the state in which the trust was formed.[4] The trust agreement may also include a provision permitting the trustee to invest trust assets in a commingled employee-benefit trust.[5] The trust instrument also will spell out the remaining powers of the employer which frequently may include the right to direct investments; also the power of the employer to change trustees and the power of the trustee to resign will be included.

b. Profit-sharing plans

The essential difference between a pension plan and a profit-sharing plan is in the nature of the employer's commitment. In a profit-sharing plan the employer does not undertake to provide defined benefits upon retirement or other separation from service. Instead the employer agrees or undertakes to contribute on a reasonably regular basis from the profits of the enterprise to the fund. The interests of employees in the fund are generally definitely ascertainable by the language of the plan, and as in the pension plan, employees may be per-

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[4] See ch. V.

[5] The typical such provision would give the trustee power to
"invest and reinvest the Trust Fund through the medium of any common, collective or commingled trust fund maintained by the Trustee, as the same may have heretofore been or may hereafter be established or amended, which is qualified under the provisions of sec. 401(a) and exempt under the provisions of sec. 501(a) of the Internal Revenue Code of 1954 as such sections may be from time to time amended or renumbered and to withdraw from such common, collective or commingled trust fund from time-to-time in whole or in part, and during such period of time as an investment through any such medium shall exist the Declaration of Trust of such fund shall constitute a part of this Agreement."

mitted (or required) to contribute. Again a range of possibilities exists for the management of such plans, but generally a trustee will be used.

c. Other corporate plans

In addition to pension and profit-sharing plans, corporate programs to provide retirement benefits may also include such entities as savings plans, to which the employer may undertake to contribute matching or other fixed portions to the employee's savings, stock-bonus plans, which are like profit-sharing plans except that employer contributions are in company stock, and bond plans, where government bonds are purchased as a funding medium. Large employers may have more than one plan, or may have a master plan which is a complex entity combining different features which are characteristic of all the plans so far described. The range and degrees of benefits to be provided, and methods of contribution and investment remains large despite some of the narrowing and conformity inspiring provisions of the laws about to be described.

2. Multiemployer Plans

Multiemployer plans are, for purposes of this Study, principally plans administered by a joint union-employer board of trustees under the Taft-Hartley Act. In the Study's sample all multiemployer plans were pension plans. which is the principal form for the plans to take because of the tendency of negotiations to produce plans providing for fixed and ascertainable pension benefits.

One characteristic which exists principally if not exclusively in multiemployer plans is portability, or continuing inclusion within the plan by an employee who transfers from one covered employer to another. To some extent, this kind of continuous inclusion provides the same sort of benefit as does vesting; since, however, there may be only one covered employer in a given region, portability is not always of practical value.

3. State and Local Government Retirement Systems

The retirement systems established for the employees of state and local government units are similar in many respects to the pension-benefit plans of private employers, with much of the variation among individual systems that characterizes the universe of corporate plans. Vested benefits may or may not be granted prior to retirement. Fixed or variable benefits may be given. Funding may be through a trust, insurance company contracts or through a fund administered by a board established by statute. One of the more significant differences between state and local government retirement systems and private plans lies in the fact that the large majority of the former call for contributions by both employees and the employer (91 out of the 94 systems in the Study's I–9 sample so provided, two provided solely for employee contributions and one for employer contributions only). Also of major significance is the fact that state and local systems are established pursuant to statutes which dictate the method of administration, and frequently limit permissible investments.[6]

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[6] 75 of the 94 systems responding to I–9 were permitted to hold common stock. At the time the questionnaires were answered the average system was permitted to hold 31⅓ percent of its assets in common stock.

4. The Tax Environment of Pension Plans and Retirement Systems

Federal income tax laws affect pension plans and retirement systems in four basic ways. (1) Taxability of contributions to the plan or system at the time they are made. (2) Taxability of income and capital gains realized by the fund at the time the income is received or the gain is realized. (3) Taxability of benefits paid to participants at the time they are paid. (4) Deductibility of employer contributions. In general, and as discussed in more detail below, if a plan "qualifies" employer contributions will not be considered income to the participant in the year in which they are made, the income and capital gains of the plan will not be subject to taxation, the participant will only be taxed as he receives benefits under the plan, which in some circumstances will be at the capital gains rates, and the employer can deduct its contributions as an expense when they are made.

a. Qualification

Section 401 of the Internal Revenue Code sets forth the criteria for the qualification of employees' pension,[7] (annuity), profit-sharing[8] and stock bonus plans.[9] In order to qualify, a trust must meet each of the following requirements:

1. It must be created or organized in the United States and it must be maintained at all times as a domestic trust in the United States.
2. It must be part of a pension, profit-sharing, or stock bonus plan established by an employer for the exclusive benefit of his employees or their beneficiaries.
3. It must be formed or availed of for the purpose of distributing to the employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with the plan.
4. It must be impossible under the trust instrument at any time before the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries.
5. It must be part of a plan which benefits prescribed percentages of the employees.
6. It must not be part of a plan which discriminates in favor of certain specified classes of employees.

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[7] For the purposes of the above qualification provisions the Regulations define "pension plan" as "a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Retirement benefits generally are measured by and based on, such factors as years of service and compensation received by the employees." Section 1.401-1(b)(1)(i).

[8] A "profit-sharing plan" is defined as "a plan established and maintained by an employer to provide for the participation of his employees or their beneficiaries. The plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment. A formula for allocating the contributions among the participants is definite if, for example, it provides for an allocation in proportion to the basic compensation of each participant." Section 1.401-1(b)(1)(ii).

[9] A "stock bonus plan" is defined as "a plan established and maintained by an employer to provide benefits similar to those of a profit-sharing plan, except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company. For the purpose of allocating and distributing the stock of the employer which is to be shared among his employees or their beneficiaries, such a plan is subject to the same requirements as a profit-sharing plan." Section 1.401-1(b)(1)(iii).

7. It must be part of a plan which provides certain nonforfeitable benefits in the event of termination or cessation of contributions.

8. If part of a *pension plan* it must be part of a plan which provides that forfeitures be not used to increase the benefits any employee would receive under the plan.

If the trust meets all of the above qualifications it will be entitled to tax exempt status under section 501 of the Code. The Internal Revenue Code does not as such attempt to dictate investments.[10] The regulations have taken the position that a "plan" when used in the foregoing "implies a permanent as distinguished from a temporary program." [11] A trust which forms part of the plan of several employers for their employees is qualified if all the requirements are otherwise met.[12] This latter provision is the basis for the qualification of pooled employee benefit trusts administered by banks. Each employer participating will make the pooled trust part of its plan, and the pooled trust for its part will provide that only qualified trusts may participate therein.[13]

b. Advantages of qualification

Once a plan qualifies, several results occur. (1) It is entitled to tax exempt status under section 501 of the Code. This means that except for nonrelated business income the income accruing to the trust is not subject to taxation. (2) Employer contributions to the plan are deductible (subject to limitations) under section 404 of the Code, and (3) the beneficiary is not taxed on employed contributions until such time as he receives benefits. If all distributions are made within one year of retirement, or other termination of employment, the amount of distributions will in general be taxed at capital gains rates.[14] If distributions are made in installments, they will be taxed as annuities under section 72 of the Code.[15]

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[10] No specific limitations are provided in sec. 401(a) with respect to investments which may be made by the trustee of a trust qualifying under sec. 401(a). Generally, the contributions may be used by the trustees to purchase any investments permitted by the trust agreement to the extent allowed by local law. However, such a trust is subject to tax under sec. 511 with respect to any unrelated business taxable income (as defined in sec. 512) realized by it from its investments. Furthermore, the tax-exempt status of the trust will be forfeited if the investments made by the trustees constitute "prohibited transactions" within the meaning of sec. 503. See also the regulations under such sections. Section 1.401–1(b)(5)(1).

[11] Section 1.401–1(b)(2).

[12] Section 1.401–1(d).

[13] See note 5 above.

[14] Section 402(a)(2). The Tax Reform Act of 1969 made certain changes in these provisions effective for taxable years following December 31, 1969. See § 402(a)(5).

[15] Section 72 and regulations thereunder provide as follows for the taxation of annuities:

> *General principal.* Section 72 prescribes rules relating to the inclusion in gross income of amounts received under a life insurance, endowment or annuity contract unless such amounts are specifically excluded from gross income under other provisions of chapter 1 of the Code. In general, these rules provide that amounts subject to the provisions of section 72 are includible in the gross income of the recipient except to the extent that they are considered to represent a reduction or return of premiums or other consideration paid. § 1.72–1(a).
>
> [W]here . . . part of the consideration for an annuity, endowment, or life insurance contract is contributed by the employer, and . . . during the 3-year period beginning on the date . . . on which an amount is first received under the contract as an annuity, the aggregate amount receivable by the employee under the terms of the contract is equal to or greater than the consideration for the contract contributed by the employee, then all amounts received as an annuity under the contract shall be excluded from gross income until there has been so excluded an amount equal to the consideration for the contract contributed by the employee. Thereafter all amounts so received under the contract shall be included in gross income. § 1.72(d)(1)(A), (B).

Amounts taxed to the employee in the year they were contributed to the contract are considered amounts contributed by the employee. Section 1.72(d)(2)(B).

The amount of deduction available to an employer is governed initially by the general requirement that compensation be reasonable.[16] The deduction provisions of section 404 are triggered by initial compliance with the requirements of either sections 162 (trade or business expenses) or 202 (production of income expenses). Then, with respect to pension plans:

> an amount not in excess of five percent of the compensation otherwise paid or accrued during the taxable year to all the employees under the trust . . . plus any excess over the amount [above] necessary to provide with respect to all the employees under the trust the remaining unfunded cost of their past and current service credits distributed as a level amount, or a level percentage of compensation, over the remaining future service of each such employee. . . . or in lieu of the [above amounts] an amount equal to the normal cost of the plan . . . plus, if past service or other supplementary pension or annuity credits are provided by the plan, an amount not in excess of ten percent of the cost which would be required to completely fund or purchase such pension or annuity credits as of the date when they are included in the plan . . . except that in no case shall a deduction be allowed for any amount (other than the normal cost) paid in after such pension or annuity credits are completely funded or purchased.[17]

Amounts paid in excess of the amount allowed as a deduction are deductible in the next year if the maximum amount deductible in that year is not reached.[18] With respect to profit-sharing plans, the basic rule is that in any one year the maximum amount that is deductible is an amount not in excess of 15 percent of the compensation otherwise paid or accrued during the taxable year to all employees under the plan. If the same employees are covered by both a pension and a profit-sharing or stock bonus plan (or annuity plan where the deductions are similar to a pension plan) the maximum total amount that is deductible in one taxable year is an amount not greater than 25 percent of the compensation otherwise paid or accrued during the taxable year to the persons who are the beneficiaries of the trusts or plans.

c. Determination of status

The Internal Revenue Code does not require advance determination that a particular plan is qualified; however, most if not all corporations having pension or profit-sharing plans are particularly concerned to assure the continuing qualification of the plans they have created. Therefore, they tend fully to avail themselves of the opportunities provided by the Internal Revenue Service to obtain advance determinations as to the qualifications of plans or as to the effect on a plan's status as a qualified plan of a change in the plan. Revenue Procedure 69–4 sets forth the procedures followed in the giving of such advance determinations. This includes determinations relative to the following types of consummated and proposed transactions.

1. The initial qualification of a plan, and, if trusteed, the status for exemption of the trust;
2. Compliance with the applicable requirements of foreign situs trusts as to taxability of beneficiaries (section 402(c)) and deductions for employer contributions (section 404(a)(4));

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[16] See Section 1.162–7(b)(3).
[17] Sections 404(a)(1)(A), (B), (C).
[18] Section 404(a)(1)(D).

3. Amendments to plans and trusts;
4. Curtailment of plans;
5. Termination of plans and trusts; and
6. The effect on the qualification of the plan, and status for exemption of the trust, of an investment of trust funds in the stock or securities of the employer or controlled corporation (ownership of 50 percent or more of all voting stock or 50 percent or more of the total value of shares of all classes of stock).

The last item above alludes to the prohibition in section 503(c) of the Code on certain types of transactions by an exempt qualified trust with the employer or a controlled corporation. Noncompliance with these provisions may lead to the loss of tax exempt status for the trust. Some evidence of the extent to which determination letters are sought is shown in Table VIII–1 which shows for years 1953 to 1970 the growth in numbers of plans held qualified in determination letters by the Internal Revenue Service. These figures do not include self-employed individuals' plans (H.R. 10 or Keogh Act plans).[19] Because, as noted above, there is no requirement that a plan seek a determination letter in order to qualify, these figures probably slightly understate for any point in time the number of active qualified plans. These figures should be contrasted with the figures released by the U.S. Department of Labor, which show that as of April 1, 1968, 33,300 pension-benefit plans were on file with the Department under the Welfare and Pension Plans Disclosure Act.[20] The Labor Department figure does not include state and local government systems, or plans which cover fewer than 26 participants, both types of which are included in the IRS figures. This most probably accounts for the difference between the two sources. Consolidating the two sources would support the statement that at year end 1969 there were about 200,000 qualified plans of which about 38,000 or 19 percent were corporate plans having 26 or more participants.

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[19] During fiscal year 1969, 131,346 H.R. 10 plans received determination letters affirming qualified status.
[20] U.S. Department of Labor, Characteristics of 157,700 Plans on File April 1, 1968 under the Welfare and Pension Plans Disclosure Act 10 (1968).

Table VIII-1
Growth of Qualified Plans*
1953 - 1969

Year	Qualified#	Terminated	Net	Cum. Balance
1953	-	-	-	22373
1954	4321	256	4065	26438
1955	3635	336	3299	29737
1956	5247	303	4944	34681
1957	6425	351	6074	40755
1958	6954	403	6551	47306
1959	7266	474	6792	54098
1960	9957	558	9399	63497
1961	9387	735	8652	72149
1962	10218	859	9359	81508
1963	11144	894	10250	91758
1964	11708	1041	10667	102425
1965	13532	1036	12496	114921
1966	18183	1210	16973	131894
1967	20522	1303	19219	151113
1968	23782	1443	22339	173452
1969	28075	1729	26346	199798

*Pension, Annuity, Profit-Sharing and Stock-Bonus Plans

#Determination Letters issued by IRS.

Source: IRS

d. State and local systems

State and local government retirement systems are also subject to the qualification scheme of the Internal Revenue Code, although it is not as central to the operation of a system as it is to corporate plans, because on the whole the deductibility of contributions to the system is not a relevant consideration due to the tax free status of the governmental employer. There remain advantages to the participant, in having direct employer contributions to the plan not treated as income to him in the year in which it is contributed, and in having the income of the fund not subject to taxation as well as in securing the favorable capital gains tax rate on some portions of the benefits ultimately paid to him.

5. Reporting Requirements Under the Federal Pension and Welfare Plans Disclosure Act

a. Corporate and multiemployer plans

Section 4 of the Act [21] makes the Act applicable to:

> any employee welfare or pension benefit plan if it is established or maintained by any employer or employers engaged in commerce or in any industry or activity affecting commerce or by an employee organization or organization representing employees engaged in commerce or in any industry or activity affecting commerce or by both.

The Act requires two kinds of reports: a description of the plan and an annual financial report. Section 6 sets forth the requirement for the description which must be filed within 90 days of the effective date of the Act or 90 days after the establishment of the plan, whichever is later. The contents of the plan description documents are prescribed by the Act [22] and the information is required to be kept current by amended filings.

Annual Report: If the plan covers 100 or more participants an annual report is required to be filed within 150 days after the end of the calendar year (or fiscal year if that is how the plan keeps its records). The Act prescribes the contents of the annual report.[23] Spe-

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[21] 29 U.S.C. §§ 301–09 (1964).

[22] 29 U.S.C. § 305(b) (1964):

The description of the plan shall be published, signed, and sworn to by the person defined as the "administrator" in section 304 of this title, and shall include their names and addresses, their official positions wth respect to the plan, and their relationship, if any, to the employer or to any employee organizations, and any other offices, positions, or employment held by them; the name, address, and description of the plan and the type of administration; the schedule of benefits; the names, titles, and addresses of any trustee or trustees (if such persons are different from those persons defined as the "administator"); whether the plan is mentioned in a collective bargaining agreement; copies of the plan or of the bargaining agreement, trust agreement, contract, or other instrument, if any, under which the plan was established and is operated; the source of the financing of the plan and the identity of any organization through which benefits are provided; whether the records of the plan are kept on a calendar year basis, or on a policy or other fiscal year basis, and if the latter basis, the date of the end of such policy or fiscal year; the procedures to be followed in presenting claims for benefits under the plan and the remedies available under the plan for the redress of claims which are denied in whole or in part.

[23] 29 U.S.C. § 306(b) (1964):

A report under this section shall be signed by the administrator and such report shall include the following:

The amount contributed by each employer; the amount contributed by the employees; the amount of benefits paid or otherwise furnished; the number of employees covered; a statement of assets specifying the total amount in each of the following types of assets: cash, Government bonds, non-Government bonds and debentures, common stocks, preferred stocks, common trust funds, real estate loans and mortgages, operated real estate, other real estate, and other assets; a statement of liabilities, receipts, and disbursements of the plan; a detailed statement of the salaries and fees and commissions charged to the plan, to whom paid, in what amount, and for what purposes. . . . The information required by this section shall be sworn to by the administrator, or certified to by an independent certified or licensed public accountant, based upon a comprehensive audit conducted in accordance with accepted standards of auditing, but nothing herein shall be constructed to require such an audit of the books or records of any bank, insurance company, or other institution providing an insurance, investment, or related function for the plan, if such books or records are subject to examination by any agency of the Federal Government or the government of any State.

cific provisions are in the Act for plans funded through different media.[24]

Other provisions of the Act require that copies of these reports be made available to participants, prescribe penalties for violation of

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[24] 29 U.S.C. § 306 (c)-(f) (1964):

(c) Unfunded plans.

If the plan is unfunded, the report shall include only the total benefits paid and the average number of employees eligible for participation, during the past five years, broken down by years; and a statement, if applicable, that the only assets from which claims against the plan may be paid are the general assets of the employer.

(d) Additional information required where benefits are provided by insurance carrier or other service or organization.

If some or all of the benefits under the plan are provided by an insurance carrier or service or other organization such report shall include with respect to such plan (in addition to the information required by subsection (b) of this section) the following:

(1) The premium rate or subscription charge and the total premium or subscription charges paid to each such carrier or organization and the approximate number of persons covered by each class of such benefits.

(2) The total amount of premiums received, the approximate number of persons covered by each class of benefits, and the total claims paid by such carrier or other organization; dividends or retroactive rate adjustments, commissions, and administrative service or other fees or other specific acquisition costs, paid by such carrier or other organization; any amounts held to provide benefits after retirement; the remainder of such premiums; and the names and addresses of the brokers, agents or other persons to whom commissions or fees were paid, the amount paid to each, and for what purpose: *Provided*, That if any such carrier or other organization does not maintain separate experience records covering the specific groups it serves, the report shall include in lieu of the information required by the foregoing provisions of this paragraph (A) a statement as to the basis of its premium rate or subscription charge, the total amount of premiums or subscription charge received from the plan, and a copy of the financial report of the carrier or other organization and (B), if such carrier or organization incurs specific costs in connection with the acquisition or retention of any particular plan or plans, a detailed statement of such costs.

(e) Holding or investing funds.

Details relative to the manner in which any funds held by an employee welfare benefit plan are held or invested shall be reported as provided under paragraphs (B), (C), and (D) of subsection (f) (1) of this section.

(f) Plans funded through trusts; plans funded through contract with insurance carrier; unfunded plans.

Reports on employee pension benefit plans shall include, in addition to the applicable information required by the foregoing provisions of this section, the following:

(1) If the plan is funded through the medium of a trust, the report shall include—

(A) the type and basis of funding, actuarial assumptions used, the amount of current and past service liabilities, and the number of employees, both retired and nonretired covered by the plan;

(B) a statement showing the assets of the fund as required by section 306(b) of this title. Such assets shall be valued on the basis regularly used in valuing investments held in the fund and reported to the United States Treasury Department, or shall be valued at their aggregate cost or present value, whichever is lower, if such a statement is not so required to be filed with the United States Treasury Department;

(C) a detailed list, including information as to cost, present value, and percentage of total funds, of all investments in securities or properties of the employer or employee organization, or any other party in interest, but the identity of all securities and the detail of brokerage fees and commissions incidental to the purchase or sale of such securities need not be revealed if such securities are listed and traded on an exchange subject to regulation by the Securities and Exchange Commission or securities in an investment company registered under the Investment Company Act of 1940, or securities of a public utility holding company registered under the Public Utility Holding Company Act of 1935, and the statement of assets contains a statement of the total investments in common stock, preferred stock, bonds and debentures, respectively, valued as provided in subparagraph (B).

(D) a detailed list of all loans made to the employer, employee organization, or other party in interest, including the terms and conditions of the loan and the name and address of the borrower: *Provided*, That if the plan is funded through the medium of a trust invested, in whole or in part, in one or more insurance or annuity contracts with an insurance carrier, the report shall include, as to the portion of the funds so invested, only the information required by paragraph (2) below.

(2) If the plan is funded through the medium of a contract with an insurance carrier, the report shall include—

(A) the type and basis of funding, actuarial assumptions used in determining the payments under the contract, and the number of employees, both retired and nonretired, covered by the contract; and

(B) except for benefits completely guaranteed by the carrier, the amount of current and past service liabilities, based on those assumptions, and the amount of all reserves accumulated under the plan.

(3) If the plan is unfunded, the report shall include the total benefits paid to retired employees for the past five years, broken down by year.

the Act's requirements as to reporting, make public all information contained in the reports, provide for investigations by the Secretary to disclose violations, provide for the retention of records, provide for the bonding of administrators, officers and employees of plans and make clear that nothing in the federal act shall prevent states from seeking additional information from plans subject to their jurisdiction, although if the state wants the same information it is to be satisfied by the federal report.

b. Excluded plans

State and local government plans are not subject to this federal reporting law by virtue of the exclusion in section 4:

(b) This chapter shall not apply to an employee welfare or pension benefit plan if—

(1) such plan *is administered* by the Federal Government or by the government of a State, by a political subdivision of a State, or by an agency or instrumentality of any of the foregoing.[25]

The phrase "is administered by" is not explicitly defined in the Act, although the word "administrator" is defined in section 5 as:

the person or persons designated by the terms of the plan or the collective bargaining agreement with responsibility for the ultimate control, disposition, or management of the money received or contributed; or . . . in the absence of such designation, the person or persons actually responsible . . . irrespective of whether such control, disposition, or management is exercised directly or through an agent or trustee designated by such person or persons.[26]

Thus, it would seem that so long as the state or local retirement system designates an agency of the state (or the state law establishing the system so designates) or in the absence of any designation the system is actually "managed" by an agency of the state there is an exemption from the Reporting Act.

There are other exemptions which are not of particular interest for our purposes, except the general exemption for plans covering fewer than 26 persons.

c. Information gaps in the Act

Although the disclosure act does require the reporting of many pieces of information concerning the financial status of plans, there are a few important information gaps. One is the result of the requirement that financial information be reported at the value used in reporting to the Treasury Department or, if such reports are not filed, at the lower of current value or aggregate cost. This means that the annual reports of any given plan may not give participants information on the current market value of plan assets. In addition, because of the lack of a consistent reporting method across all plans, these reports do not readily generate information on the universe of plans reporting under the Act.

Another gap arises from the fact that securities held in the plan are not reported by issuer which would permit the evalaution of portfolio characteristics. In addition, the absence of reports on cash flow, and purchases and sales, with market valuations of the portfolio as these occur, make it impossible to calculate volatility-adjusted return measures of the kind used in certain sections of this Study.[27]

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[25] 29 U.S.C. § 303(b)(1) (emphasis added).
[26] 29 U.S.C. § 304(b) (1), (2).
[27] For example, ch. IV.I.

Information on fees and expenses incurred by plans reported under the Act is limited because the Act requires disclosure of only "salaries and fees and commissions charged to the plan. . . ." On Study Form I-25, respondents were asked to separate fees and expenses attributable to accounts into those charged the account and those paid other than from the account. Analysis of these data shows that over the five year period 1965 through 1969, 63 percent of the dollars charged all reporting accounts as fees or expenses were paid other than from the account; also, over the same period, 63 percent of the reporting accounts had some fees or expenses paid other than from the account.

d. Current proposals to amend the Act

In recent years several proposals have been made in Congress to amend or supplement the Welfare and Pension Plans Disclosure Act. The major bills receiving consideration prior to the end of the 91st Congress were the Administration Bill, H.R. 16462 and S. 3584, entitled "Employee Benefits Protection Act"; two bills introduced by Representative Dent, H.R. 1045 which deals with vesting, funding and insurance and H.R. 1046 which deals with fiduciary responsibility and disclosure requirements; and a bill introduced in the Senate by Senator Javits, S. 2167, with House counterpart H.R. 11884, which treats both vesting, funding and insurance as well as disclosure and fiduciary responsibility and proposes the establishment of a federal agency, the "United States Pension and Employee Benefit Plan Commission," to supervise most aspects of plan regulation.[28]

It is not clear as this report is written whether or when legislation in this area ultimately will emerge from the Congress; however, because of the continuing concern it is probable that some legislation may emerge concerning increased disclosure and stricter standards of fiduciary responsibility by plan administrators and trustees.

To date, none of the bills would extend the coverage of the federal act to plans administered by agencies of state governments, so these increasingly important holders of equity will continue not to be required to submit to uniform reporting.

In the area of disclosure, the provision in the administration bill requiring "a schedule of all investments of the fund showing, as of the end of the fiscal year—(A) the aggregate cost and aggregate value of each security, by issuer" would tend to fill two of the gaps in the present reporting scheme. Holdings of individual issues would be given and both cost and aggregate value would be shown.

6. Multiemployer Plans and the Taft-Hartley Act

In general, section 302 of the Taft-Hartley Act makes it unlawful for an employer to give money or any other thing of value to representatives of a labor organization and for such representatives to request, receive or accept such payments, subject to the exemption in subsection (c):

> The provisions of this section shall not be applicable . . . (5) with respect to money or other thing of value paid to a trust fund established by such representa-

[28] A good brief description of the provisions of these bills can be found in the 1968, 1969 and 1970 reports of the Committee on Pension, Welfare and Related Plans of the American Bar Association Section of Labor Relations Law.

tive. for the sole and exclusive benefit of the employees of such employer, and their families and dependents . . . : *Provided*, That (A) such payments are held in trust for the purpose of paying, either from principal or income or both, for the benefit of employees . . . for hospital care, pensions on retirement . . . ; (B) the detailed basis on which such payments are to be made is specified in a written agreement with the employer, and employees and employers are equally represented in the administration of such fund . . . and shall also contain provisions for an annual audit of the trust fund, a statement of the results of which shall be available for inspection by interested persons at the principal office of the trust fund . . . ; and (C) such payments as are intended to be used for the purpose of providing pensions or annuities for employees are made to a separate trust which provides that the funds held therein cannot be used for any purpose other than paying such pensions or annuities. . . .

Penalties are provided for violation of this section, one year's imprisonment or $10,000.

7. The Securities Laws

The following sections discuss the manner in which the federal securities laws [29] applied to pension-benefit plans in the years leading up to and during the period covered by this Study. Consideration will be given to the way the Acts govern pension and profit-sharing plans, including both contributory and noncontributory plans, as well as plans which invest principally in securities of the sponsoring employer, or which are managed through the medium of commingled accounts. Particular attention will be paid to the history and manner in which variable annuities and insurance company separate accounts came under the aegis of the Commission. Finally, consideration will be given to the impact of the Investment Company Amendments Act of 1970 (1970 Act).[30]

a. The Securities Act of 1933

The Securities Act of 1933 provides for the regulation of the manner in which securities are offered and sold. The central definition of the Act, and the key to its applicability is the definition in section 2(1) of "security" which "means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

This definition which is quite broad in the Act has been broadly interpreted by the courts as well, with the principal inquiry generally being whether there is an identifiable investor interest at stake. The regulatory scheme established by the Securities Act is principally one requiring full disclosure of all material facts concerning the issue of a security to enable the prospective purchaser to make the decision whether to buy the security with all the facts before him. Before a security

[29] The Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (1964) and the Investment Company Act of 1940, 15 U.S.C. §§ 80a–1—80a–52 (1964), are the acts of principal concern in the context of this chapter.
[30] Pub. L. No. 91–547 (December 14, 1970).

may be sold or offered for sale there must be with respect to such security an effective registration statement. The Commission is given authority to delay or suspend the effectiveness of a registration statement if it appears that the "satement includes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading." The Act also regulates the contents of prospectuses, which are defined by section 2(10) to mean "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security. . . ." Criminal and civil penalties are established for violations of the Act and for the making of untrue statements or the willful omission of material facts. Given this basic scheme, the Act also contains two kinds of exemptions—complete exemptions from all but the antifraud provisions, and partial exemptions for certain kinds of transactions. In the latter category, section 4(2) of the Act exempts from the provisions of section 5 (requiring a registration statement to be in effect before an offer or sale may be made and requiring the delivery of a statutory prospectus) though not from the antifraud provisions "transactions by an issuer not involving any public offering." Of importance to this chapter, securities exempted from all but the antifraud provisions include those issued or guaranteed by a state or public instrumentality thereof, or any national bank, or banking institution organized under the laws and subject to the regulation of a state, "any insurance or endowment policy or annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia," or any security which is sold only to persons resident within a single state or territory issued by a person resident and doing business or incorporated within such state or territory.[31]

(1) *Corporate pension and profit-sharing plans—(a) Plans not providing for voluntary contributions.*—In the case of plans which are unfunded (pay-as-you-go basis plans) and in the case of plans where contributions to the funding medium consist of either employer money only or employee contributions which are required as a condition of employment, the Commission staff has taken the position that the Securities Act does not apply because there is no "sale" or "offer for sale" of a security.[32] Although the employees' interests in the plan (whether the plan's assets are invested through a funding medium or consist solely of an obligation of the employer recoverable from the general assets of the employer) may be recognized to be "securities" within the Act, the absence of a volitional element [33] on the part of the employees in acquiring these interests is the basis for the position. While this result may not be compelled by the statutory definition of "sale," [34] the result is consistent with the basic scheme of the Act to provide would-be purchasers with information adequate to make an informed opinion

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[31] Sections 3(a)(8). 3(a)(11).

[32] 1 CCH. Fed. Sec. L. Rep. ¶ 2231.21. (1941.)

[33] It has been held that volition on the part of the seller is not necessary to the finding of a sale under the Securities Act. Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), *cert. denied,* 398 U.S. 937 (1967) (short-form merger).

[34] "The term sale or sell shall include every contract of sale or disposition of a security or interest in a security, for value." Sec. 2(3).

as to whether to purchase—assuming that there is a real difference between employer and employee contributions.[35]

(b) *Plans providing for voluntary employee contributions.*—In the situation where the employee may make voluntary contributions to the plan (or in the case of certain savings plans) the absence-of-volition rationale cannot come into play. However, the Commission staff has in the past taken a no-action position "that no question will be raised with respect to the registration of participations in a voluntary contributory pension, profit-sharing, or similar plan that does not invest in the securities of the employer company in an amount exceeding the company's contribution." If the plan exceeds this amount in investments in company securities, both the company stock and the interests in the plan must be registered under the Securities Act.[36]

(*2*) *Multiemployer plans.*—Multiemployer plans, to the extent that they are funded exclusively from contributions of employers or nonvoluntary employee contributions are treated in the same manner as the plans of single or related employers. The fact that the trust is administered by a joint union-employer board does not materially distinguish the situation.

(*3*) *State and local government systems.*—In the situation of funds established by public agencies, as is the case with state and local government retirements systems, the exemption in section 3(a)(2) of the Securities Act for securities issued or guaranteed by state governments or public agencies would operate to exclude the application of the Securities Act to interests of employees in such funds regardless of the voluntary nature of the contributions or the types of investments to be made by the system. If, however, the systems are funded through media administered by a nongovernmental agency questions may arise under the securities laws.

b. The Investment Company Act of 1940

Based on the belief that more than disclosure is required to protect the interests of investors in investment companies, the Investment Company Act establishes a system of registration plus regulation as to investments, policy and transactions. Section 3(a) of the Act defines an investment company as any issuer which—

> (1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, or trading in securities;
>
> (2) is engaged in or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or
>
> (3) is engaged in or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

Section 3(c) goes on, however, to exclude from the definition of investment company, inter alia, the following:

> (3) any bank or insurance company; . . . any common trust fund or similar fund maintained by a bank exclusively for the collective investment and

[35] *See generally* Mundheim & Henderson, *Applicability of the Federal Securities Laws to Pension and Profit-Sharing Plans*, 29 Law & Comtemp. Prob. 795, 805–08 (1964), for a good general discussion of the subject.

[36] This position has been codified by the 1970 Act amendments to sec. 3(a)(2) of the Securities Act Pub. L. No. 91–547, § 27 (December 14, 1970), as amended Pub. L. No. 91–567 § 6(a) (December 22, 1970).

reinvestment of moneys contributed thereto by the bank in its capacity as trustee, executor, administrator, or guardian; . . .
(13) any employees' stock bonus, pension, or profit-sharing trust which meets the conditions of section 165 of the Internal Revenue Code, as amended.[37]

The exclusion in the latter subsection effectively removes from Investment Company Act regulation the large bulk of pension and profit-sharing trusts which do in fact qualify under the provisions of the Internal Revenue Code. Since these trusts are exempt only if they are part of qualified plans, the Commission staff has interpreted the exemption as applying also to the related plan or plans.

c. Bank managed pension and profit-sharing plans and commingled trust funds—applicability of the securities acts

One of the vehicles by which banks are servicing the needs of pension plan customers is the device of the commingled fund. Such a fund is created by drawing assets from many plans into one fund which is then the "managed" entity. Each participating trust is credited with the amount of its initial contribution, and experience of the fund. In general, no fee is charged the commingled fund itself, although participating plans are charged a fee for the management of their trusts, usually a fee which is related to the amount of assets under management including assets invested in the commingled fund.

If the participating plans are all qualified plans under the Internal Revenue Code then the trusts which form parts of their plans are exempt from taxation, as will be the commingled fund itself. This result has led the Commission to interpret the exemption in section 3(c)(13) of the Investment Company Act as applicable to the commingled fund itself.[38]

The Commission has also interpreted this exemption as applicable to commingled funds containing assets of self-employed individuals and owner employees some or all of whom are employees within the meaning of section 401(c) of the Internal Revenue Code (H.R. 10 plans). However, the Commission has taken the view that because of the manner in which interests in such pooled trusts are sold, securities are issued by such funds and it requires registration of interests in funds pooling assets of H.R. 10 plans under the Securities Act.[39]

As discussed in chapter V, much controversy has been generated recently about commingled funds not containing trust assets but rather assets that a bank is managing under agency contracts. While consideration of such funds goes beyond the scope of this chapter relating to retirement moneys, these concerns have interacted with the regulatory pattern of assets of retirement plans and must be kept in mind to understand fully the regulatory scene.

8. Insurance Company Separate Accounts and Variable Annuities—Application of the Securities Laws

a. Background

In efforts described more fully in chapter VI of the Study, during the late fifties and early sixties, insurance companies, partly due to

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[37] This subsection has been amended by the 1970 Act, Pub. L. No. 91–547, § 3(b)(5) (December 14, 1970), to include collective trust funds and insurance company separate accounts.

[38] This position has now been codified by the 1970 Act. Pub. L. No. 91–547, § 3(b)(5) (December 14, 1970).

[39] This position has also been codified by the 1970 Act. *Id.* § 27(b).

competition with banks for the management of pension-benefit plan dollars, sought new vehicles through which to offer management of equity portfolios to their customers. Among these vehicles were individual and group variable annuity contracts funded in separate accounts, and separate accounts which held employer contributions and permitted the employer to assume the investment risks of the account. These efforts brought insurance companies within the jurisdiction of the Commission and the scope of the Securities Act of 1933, the Investment Compay Act of 1940, and for some purposes the Securities Exchange Act of 1934.

b. Commission action

The history of SEC involvement with insurance companies begins with the individual variable annuity business in the *VALIC* case in 1957,[40] wherein it was ultimately established that an insurance company predominantly in the business of issuing variable annuity contracts to individual purchasers was issuing securities within the meaning of the Securities Act and was an investment company within the scope of the Investment Company Act. Following *VALIC*, the next major step was taken in the *Prudential* case,[41] in which it was established that a traditional insurance company which predominantly issued traditional insurance policies came within the scope of both the Securities Act and the Investment Company Act by establishing a separate account to fund individual annuity contracts. The separate account is viewed as an investment company, and the interests in the account as securities. These cases left open the question whether the assumption of *some* investment risk by the insurance company would be sufficient to bring the variable annuity contracts back into the conception of traditional insurance business and the exemptions provided by the Securities Act and the Investment Company Act.[42] This question was settled in the *United Benefit* case,[43] decided in 1967, where the Court took the view that United Benefit's "flexible fund annuity" did constitute a security not exempted from registration under the Securities Act during its accumulation phase, even though a minimum value at the end of this phase was guaranteed by the insurance company, and even though during the payout period all investment risk was on the insurer. The Court in effect separated the accumulation phase from the pay-out phase. In analyzing the accumulation phase it pointed out that the guaranteed portion of the contract could always be met by the insurer funding a portion of the contributions in relatively safe investments or by guaranteeing such a low value that even very poor investment results would still be adequate to meet the guarantee.

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[40] SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959), *reversing*, 257 F.2d 201 (D.C. Cir. 1958). Both the district court and the court of appeals ruled against the Commission, but the Supreme Court reversed in a 5–4 decision.

For more detailed examinations of the Commission's move into regulation of insurance company products and the litigation which has resulted, see Galston, *The Regulation of Variable Annuities*, 1967 Proc. Sec. of Ins. Law, A.B.A. 348; McDougal, *Variable Annuities and Separate Accounts, the Investment Company Act of 1940*, 1967 Proc. Legal Sec. Am. Life Convention 78.

[41] Prudential Ins. Co. v. SEC, 326 F.2d 383 (3d Cir. 1964), *cert. denied*, 377 U.S. 953, affirming Investment Company Act Release No. 3620 (1963).

[42] "The companies that issue these annuities take the risk of failure. But they guarantee nothing to the annuitant except an interest in a portfolio of common stocks or other equities—an interest that has a ceiling but no floor. There is no true underwriting of risks, the one earmark of insurance as it has commonly been conceived of in popular understanding and usage." SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65,, 71–73 (footnotes omitted).

[43] SEC v. United Benefit Life Ins. Co., 387 U.S. 202.

With the establishment of the above principles in the individual annuity area, the question arose as to whether any statutory exemptions were applicable to contracts offered in connection with employee-benefit plans qualified under the Internal Revenue Code and funded in insurance company separate accounts. Since no such exemptions were available, the Commission and staff took no-action positions and used the Commission's rulemaking power to give the insurance industry what the Commission considered appropriate relief.

The initial step in this administrative process was the adoption in 1963 of Rule 3c-3 under the Investment Company Act[44] followed by the adoption a few months later of Rule 156 under the Securities Act.[45] It should be noted that these rules provided a complete exemption from the Investment Company Act and an exemption from the registration requirements of the Securities Act for contracts issued in connection with qualified plans which prohibited the allocation of employee money to the separate account. These exemptions applied only where fixed benefits were to be paid; however, in 1964, Rule 3c-3 was amended to permit the payment of variable benefits, with Rule 156 being

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[44] SEC Investment Co. Act Release No. 3605 (January 7, 1963). The text of the Rule is as follows:

Rule 3c-3. Exemption for Certain Group Annuity Contracts Which Provide for Administration of Funds Held by an Insurance Company in a Segregated Account.

(a) Any transaction by an insurance company, as defined in Section 2(a) (17) of the Act, involving a group annuity contract or contracts with an employer, employers or persons acting on their behalf (herein called the "employer") providing for the allocation of part or all of the employer's contributions thereunder to one or more separate accounts shall be exempt from the provisions of the Act, and no company, as defined in Section 2(a)(8) of the Act, shall be deemed to have become subject to the Act by virtue of having engaged or participated in any of such transactions, *provided that* the contract—

(1) contains an undertaking by the insurance company to provide, to the extent of the employer's interest in such separate account, for the future issue of guaranteed annuities payable to covered employees on their retirement in fixed dollar amounts.

(2) is made in connection with a plan which meets the requirements for qualification under Section 401 of the Internal Revenue Code, or the requirements for deduction of the employer's contributions under Section 404(a)(2) of said Code whether or not the employer deducts the amounts paid for the contract under such section, and which plan does not provide for retirement benefits payable to covered employees which are measured by the investment results of assets allocated to a separate account, as defined herein, maintained by such insurance company.

(3) prohibits the allocation to the separate account of any payment or contribution made by an employee, and

(4) covers at least 25 employees at the time of its execution.

(b) "Separate account" as used in this rule shall mean an account established and maintained pursuant to the law of any state or territory of the United States or the District of Columbia, under which income, gains and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains or losses of the insurance company and which does not include the reserves maintained for guaranteed annuities in the course of payment.

(c) All references herein to sections of the Internal Revenue Code mean said sections as now or hereafter amended, or any corresponding provisions of prior or subsequent United States Revenue laws.

(d) The exemption provided in this rule shall apply notwithstanding that there is no guarantee by the insurance company of or with respect to the investment results of assets allocated to a separate account.

[45] Securities Act Release No. 4627 (August 1, 1963). The text of the Rule is as follows:

Rule 156.—Definition of "transactions by an Issuer Not Involving Any Public Offering" in Section 4(1) of the Act for Transactions Exempted by Rule 3c-3 under the Investment Company Act of 1940.

The phrase "transactions by an issuer not involving any public offering" in Section *4(1)* of the Act shall include any transaction with respect to a separate account group annuity contract with an employer, employers or persons acting on their behalf (herein called the "employer") provided that the contract (i) meets the conditions and limitation set forth in Rule 3c-3 under the Investment Company Act of 1940 so that the transaction is exempt thereunder, (ii) is separately negotiated with such employer, and (iii) is not advertised in any written communication which, insofar as it relates to a separate account group annuity contract, does more than identify the insurance company, state that it is engaged in the business of writing such contracts and invite inquiries in regard thereto. The limitation of clause (iii) shall not apply to disclosure made in the course of direct discussion or negotiation of such contracts.

The reference in the second line to "Section 4(1)" was changed to "Section 4(2)" by Securities Act Release No. 4761.

amended by implication.[46] This amendment to Rule 3c-3 also explicitly excluded from the operation of the rule H.R. 10 plans, and made other changes.

Following this amendment of Rule 3c–3, a period of about five years ensued in which no further rules were adopted. Except for two exceptions described below, companies wishing to do business which did not meet the exemptions had to proceed by registering their separate account as an investment company and the interests therein as securities. A number of companies took this route, seeking and receiving in the process individual exemptions from various provisions of the Acts.[47]

The exceptions referred to above concern the following situations. No-action letters, qualified by the advice that the matter was under continuing review and therefore subject to change, were given by the staff to companies that sought to offer group contracts for H.R. 10 plans. These letters stated that the staff would not recommend action under the Investment Company Act provided that the Securities Act registration provisions were complied with for interests in such separate accounts. The second situation evolved out of the staff position that contracts funding plans which gave employees the option to elect at retirement either a fixed or a variable payout were not contracts which prohibited the allocation of employee money to the account, since the employee could in effect contribute his vested benefit, and were therefore not within the exemptions provided by Rule 3c–3. No-action letters qualified by the advice that the matter was under continuing review and therefore subject to change were given in this situation as well.

By 1967, the insurance industry began to press for the adoption of further exemptive rules to permit insurance companies to compete more readily with banks for the management of pension plan dollars, and also for a series of rules to codify the exemptions which were given to separate accounts registering as investment companies, either because they were funding individual variable annuity contracts or because they were funding group business not qualified under Rule 3c–3, or which had not received a no-action letter.

A process of discussion and review of draft proposals between the staff of the Commission and representatives of the insurance industry culminated in 1969 in the promulgation of a series of rules codifying exemptions for registering separate accounts,[48] and Rule 6e–1 under the Investment Company Act, further exempting contracts funding qualified pension plan business, including H.R. 10 plans, whether or

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[46] SEC Investment Company Act Release No. 4007 (July 2, 1964). The amended clause (1) of section (a) is as follows:

(1) contains an undertaking by the insurance company to provide, to the extent of the interest in such separate account of the employer and of the covered employees, for the future issue of annuities payable to covered employees on or after their retirement, whether such annuities are payable in fixed or variable dollar amounts, or both.

[47] *See generally* IV Loss, *Securities Regulation* 2517–25 (Supp. 1969), and proceedings cited therein, for a review of the manner in which insurance companies have organized their separate accounts to meet Investment Company Act strictures. For discussion of problems raised for insurance companies having separate accounts see Wilson, *Problems Raised by Securities Act of 1933, Including Proposed Rule 156*, 1968 Proc. Legal Sec. Am. Life Convention 36; Nelson, *Problems Raised by the Investment Company Act of 1940, Including Proposals for Revised Rules, id.* at 77; Kenney, *Problems Raised by Securities Exchange Act of 1934, id.* at 100.

[48] SEC Investment Company Act Release No. 5738 (July 10, 1969) (New Rules 14a–2, 15a–3, 16a–1, 32a–2, 22e–1, 27c–1, 27a–1, –2 and –3, and 0–1 (e)).

not employee money was permitted to be allocated to the separate account. A companion amendment to Rule 156 under the Securities Act was also adopted.[49] More recently, the Commission announced the rolling back of the staff's no-action positions on H.R. 10 plans and plans permitting employees to elect variable benefits under Rule 3c-3 described above, and stating that with the adoption of Rule 6e-1 there was now an appropriate way for such accounts to be treated by the Commission.[50]

c. The Investment Company Amendments Act of 1970 [51]

In provisions effective December 14, 1970, and January 1, 1971, the 1970 Act amends the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Company Act of 1940 so as to reduce substantially federal regulation under the securities laws of the funding mechanisms of pension-benefit plans qualified under the Internal Revenue Code of 1954.

The 1970 Act amends section 3(a)(2) of the Securities Act, adding to the classes of securities exempted from all but the antifraud provisions of the Act the following:

> . . . any interest or participation in a single or collective trust fund maintained by a bank or in a separate account maintained by an insurance company which interest or participation is issued in connection with (A) a stock bonus pension, or profit-sharing plan which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954, or (B) an annuity plan which meets the requirements for the deduction of the employer's contribution under section 404(a)(2) of such Code, other than any plan described in clause (A) or (B) of this paragraph (i) the contributions under which are held in a single trust fund maintained by a bank or in a separate account maintained by an insurance company for a single employer and under which an amount in excess of the employer's contribution is allocated to the purchase of securities (other than interest or participations in the trust or separate account itself) issued by the employer or by any company directly or indirectly controlling, controlled by or under common control with the employer or (ii) which covers employees some or all of whom are employees within the meaning of section 401(c)(1) of such Code. The Commission, by rules and regulations or order, shall exempt from the provisions of section 5 of this title any interest or participation issued in connection with a stock bonus, pension, profit-sharing, or annuity plan which covers employees some or all of whom are employees within the meaning of section 401(c)(1) of the Internal Revenue Code of 1954, if and to the extent that the Commission determines this to be necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title.[52]

In addition, the definitions section of the Securities Act is amended by the addition of definitions of "insurance company" and "separate account." [53] An amendment to section 3(a)(12) of the Securities Exchange Act adds to the category "exempted securities"

> any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, ad-

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[49] SEC Investment Company Act Release No. 5741 (Rule 6e-1) and Securities Act Release No. 4986 (Rule 156) (July 15, 1969).
[50] SEC Investment Company Act Release No. 6124 (July 21, 1970).
[51] S. 2224, enacted as Pub. L. No. 91-547 (December 14, 1970), *as amended* by S. 3431, § 6(a), enacted as Pub. L. No. 91-567 (December 22, 1970). Hereinafter collectively referred to as the 1970 Act. Pub. L. No. 91-567 made a clarifying amendment to section 27(b) of S. 2224. This amendment took effect on January 1, 1971.
[52] Pub. L. No. 91-547, § 27(b), *as amended* by Pub. L. No. 91-567, § 6(a).
[53] Pub. L. No. 91-547, § 27(a).

ministrator, or guardian; any interest or participation in a collective trust fund maintained by a bank or in a separate account maintained by an insurance company which interest or participation is issued in connection with (A) a stock-bonus, pension, or profit-sharing plan which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954, or (B) an annuity plan which meets the requirements for the deduction of the employer's contribution under section 404(a)(2) of such Code, other than any plan described in clause (A) or (B) of this paragraph which covers employees some or all of whom are employees within the meaning of section 401(c)(1) of such Code.[54]

Section 12(g)(2) of the Securities Exchange Act is amended through the addition of a new subsection (H):

(H) Any interest or participation in any collective trust funds maintained by a bank or in a separate account maintained by an insurance company which interest or participation is issued in connection with (i) a stock-bonus, pension, or profit-sharing plan which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954, or (ii) an annuity plan which meets the requirements for deduction of the employer's contribution under section 404(a)(2) of such Code.[55]

The Investment Company Act of 1940 is amended by adding the following definition of "separate account" in section 2(a)(37):

(37) "Separate account" means an account established and maintained by an insurance company pursuant to the laws of any State or territory of the United States, or of Canada or any province thereof, under which income, gains and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains or losses of the insurance company.[56]

This definition is the same as the definition added to the Securities Act and it is incorporated by reference into the Securities Exchange Act.[57] The major substantive change in the Investment Company Act is made in the amendment of subsection 3(c)(11), formerly 3(c)(13), so as to exempt from the Act:

(11) Any employees' stock bonus, pension or profit sharing trust which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954; or any collective trust fund maintained by a bank consisting solely of assets of such trusts; or any separate account the assets of which are derived solely from (a) contributions under pension or profit-sharing plans which meet the requirements of such section or the requirements for deduction of the employer's contribution under section 404(a)(2) of such Code, and (b) advances made by an insurance company in connection with the operation of such separate account.[58]

The effect of these amendments is that registration under the Securities Act is now required for interests or participations in separate accounts or single or collective trust funds used to fund qualified pension-benefit plan assets in only two situations. The first situation involves separate accounts or single trust funds for the plans of a single employer under which amounts in excess of the employer's contribution

[54] Pub. L. No. 91–547, § 28(a).
[55] Pub. L. No. 91–547, § 28(c).
[56] Pub. L. No. 91–547, § 2(a)(1)(4).
[57] Pub. L. No. 91–547, § 28(b). The fact that this definition has been adopted by the statute does not mean that compliance with the conditions set forth in Rule 0–1(e) under the Investment Company Act is no longer necessary for the availability of exemptive Rules 14a–2, 15a–3, 16a–1, 22e–1, 27a–3, 27c–1 and 32a–2 under the Act.
[58] Pub. L. No. 91–547, § 3(b)(5).

are allocated to the purchase of the employer's securities.[59] The second situation involves separate accounts or trusts funding H.R. 10 plans; however, in this situation the Commission is given express authority to exempt such separate accounts or trusts from the registration provisions upon finding such exemption to be appropriate. The amendments to the Investment Company Act, on the other hand, exempt from the Act's coverage separate accounts and trusts which fund plans of the type not exempted from the Securities Act.

Taken together, these amendments provide more extensive exemptions from the Acts than were previously available under Commission Rules 3c-3 and 6e-1 under the Investment Company Act, and Rule 156 under the Securities Act. As this chapter is written, it is the view of the Commission staff that the above rules are without continuing effect because the subject matter has been superseded by the statute.

C. CORPORATE PENSION-BENEFIT PLANS

1. Overview

a. Sampling procedures adopted

In undertaking a study of corporate pension-benefit plans[60] the Study was faced with a universe of uncertain dimensions. As discussed above, Internal Revenue Service data indicated the existence of some 200,000 qualified plans, but these data include plans of state and local governments, discussed in part E, multiemployer plans, discussed in part D, and the plans of other organizations such as nonprot corporations which are not considered in this chapter.[61] Labor Department figures based on reports filed under the Welfare and Pension Plans Disclosure Act reveal only 33,000 plans, but these figures do not include plans covering fewer than 26 employees nor plans of state and local governments and nonprofit organizations. Commission data on assets of plans based on approximately the same universe as the Labor Department figures show that at year end 1969 noninsured plans had total assets approaching $90 billion at book value.[62]

The Study decided to use a sampling procedure which would permit the development of accurate information about the greatest number of dollars in this area while keeping the numbers of questionnaire respondents to a minimum. In a process described more fully in the appendix of this chapter, the Study selected a sample of 90 firms [63] having

[59] Securities of companies controlling, controlled by or under common control with the employer are considered securities of the employer; however, interests or participations in the trust or separate account itself are not considered to be securities of the employer. Thus, the mere fact that the pension plan of an insurance company is funded in a separate account maintained by the insurance company would not bring the interests or participations in such separate account within the exclusory provisions of part (i) of the new section 3(a)(2).

[60] The Study used the definition of pension-benefit plan contained in the Welfare and Pension Plans Disclosure Act, 29 U.S.C. § 302(2) (1968).

[61] See Table VIII-1 below, and accompanying text for tabulation of Internal Revenue Service figures on plans receiving determination letters confirming their qualified status and discussing the composition of the figures.

[62] SEC, Stat. Bull. 19 (April 1970). Figures for market value at year end 1969 were not available, though they could be expected to be greater than the book value figures. Comparable figures for year end 1968 were: book value $80.28 billion; market value $92.70 billion.

[63] For purposes of this Study affiliated companies are considered one firm even though each company may have one or more than one separate plan.

large pension-benefit plans to receive the first stage or screening questionnaire. This questionnaire, I–8,[64] was designed to develop basic information about pension-benefit plans and to provide a basis for selection of a sample of separately managed accounts [65] to receive the stage-two, detailed questionnaires. The development of a subuniverse of separately managed accounts was based on the belief that it was at this level that the day-to-day investment decisions affecting markets and issuers are made. Of course, fundamental guidelines may be handed down from a higher level, but it is the management of accounts that results in the purchase or sale of securities.

The 90 firms selected had 135 pension-benefit plans which in turn were divided into 371 separately managed accounts. These plans held at June 1969 total assets of approximately $47.2 billion and common stock and securities convertible into common stock of approximately $30.3 billion. Thus, the 90 firms' plans accounted for about 46 percent of the total assets in the pension-benefit plan universe. Table VIII–2 below shows the concentration of assets within the sample both in terms of total assets and common and convertibles. It should be noted that although the same nine firms' plans contribute to the percentages reflected in both the asset and the stock column, a given firm may not be the largest in terms of both assets and common stock.

Following the tabulation of data supplied in the screening questionnaire, the sample of separately managed accounts was selected for the second stage, detailed questionnaires.[66] This sample consisted of 155 accounts belonging to 108 pension-benefit plans of 78 firms. There were 117 accounts managed by bank trust departments, 16 managed by investment advisory firms and 22 managed internally. According to the data supplied on I–8, these 155 accounts had total assets of $35.9 billion and common stock and convertible securities of $24.8 billion. Table VIII–3 below shows I–8 data on assets and stock classified by manager type for the entire I–8 sample and the second stage sample.

b. Data-presentation method

In this chapter data are presented generally in one of two forms, with cells of tables being filled either with dollar amounts or percentages of accounts. In both forms the number of accounts providing the base for the figures also are given. Although the focus of the chapter is on accounts, some information was collected at the plan level only. In these cases, the characteristics being described have been attributed to each account of the plan providing the response and tabulations have been made based on accounts.

[64] Reproduced in Supp. Vol. II.

[65] "Separately managed account" was defined as any account "which either is managed by a separate person or group or which, although managed by one manager, is separate because of distinct investment objectives, or different sources of contributions." "Manager" was defined to mean "the investment firm, bank, insurance company or other investment adviser, or the person or committee (if managed internally) which makes day-to-day decisions on the purchase or sale of securities, *even though* some other group or person may have ultimate responsibility for the plan of which the fund is a part. For example, if an investment adviser makes only portfolio recommendations and these recommendations are seldom if ever overruled by a group with ultimate authority, the investment adviser *is* the manager for our purposes. Last, depending on the structure of a particular plan, the 'manager' might also be the administrator of the plan or the corporate trustee of the plan or might be some other person or group."

[66] The sampling process is described in app. A to this chapter.

Table VIII-2
Corporate Pension-Benefit Plans

Total Assets and Common Stock
Concentration Figures

Number of largest firms' plans	Percent of sample's total assets	Percent of sample's common stock
1	11.87	7.89
2	20.12	16.86
3	27.01	25.59
4	32.96	32.75
5	38.35	38.18
6	42.87	43.36
7	47.22	47.29
8	50.36	50.06
9	52.42	52.82

Table VIII-3
Corporate Pension-Benefit Plans
Assets and Common Stock of Samples
by Manager Type in Millions of Dollars

	I-8 Sample			Stage 2 Sample		
Managed Type	No.	Assets	Stock	No	Assets	Stock
Bank-managed	253	28164.9	18985.2	117	21907.3	14648.2
I/A-managed	35	1260.3	951.6	16	700.0	586.8
Self-managed	27	14245.7	10042.9	22	13278.0	9528.7
Insured*	56	3511.7	271.2	0	-	-
Total	371	47172.6	30251.0	155	35885.3	24763.7

*Although I-8 was sent principally to firms known to have large noninsured plans, some insured accounts were reached in the sample. These are not necessarily representative of insured accounts generally or even of large insured accounts and they were not analyzed or used in determining the stage-2 sample.

Because the sample of accounts contained a number of accounts of profit-sharing plans as well as pension plans, most of the Tables for this chapter have two parts; the first part (designated by an "A" in parenthesis following the Table number) classifies accounts into manager type, and within the bank-managed group according to the account size strata from which they were selected;[67] the second part (designated by "B" in parenthesis following the Table number) separates out profit-sharing plans into two classes, managed and unmanaged, and combines the remaining bank-managed pension plan accounts into a single class. It was possible to identify profit-sharing plan accounts on returns to the account questionnaire package by reason of answers to questions on use of actuarial consulting firms or the rate of return assumed in the plan's actuarial calculations,[68] or from descriptive statements provided voluntarily by the respondent. The unmanaged category consists of accounts which have severe restrictions on investments, usually due to requirements of the plan that only stock of the employer corporation be held, or that only series "E" bonds be held, or some similar restriction.

Presentation of data in this dual method has some advantages. First, it permits comparisons to be made between pension and profit-sharing plans' accounts. Second, it permits comparisons to be made among the three manager types, bank-managed, investment-adviser-managed and self-managed. Third, within the bank-managed class it permits comparisons to be made of accounts in different size strata.

c. General characteristics of large pension-benefit plans

Some of the basic characteristics of large noninsured corporate pension-benefit plans already have been presented, specifically, the degree to which total assets and common stock are concentrated in the plans of a few firms and the extent to which these large plans are divided into separate accounts for the management of assets. Although there was some evidence from Form I–8 that these large plans' assets were being divided up for management purposes among different managers and types of managers, management of these accounts still is highly concentrated among a few of the larger New York banks. Of the 253 bank managed accounts reported on Form I–8 four banks (7.41 percent of the 54 bank managers) managed 119 or 47.04 percent of the accounts. If the larger number of noninsured accounts is taken as the base (adding 35 investment adviser managed and 27 self-managed) the four banks then represent 4.17 percent of the number of managers, and their 119 accounts 37.78 percent of the 315 accounts. Management of the 35 investment adviser managed accounts is similarly concentrated; the top four of 17 managers (23.53 percent) manage 16 of 35 accounts (45.71 percent). The four banks managing the greatest assets managed 32.50 percent of the assets reported on Form I–8; while the four banks managing the greatest amount of common stock managed

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[67] See app. A to this chapter for elaboration of the stratification process used to select a sample of bank-managed accounts, and of the adjustment process used to take this process into account in preparing the Tables.

[68] For example, Tables VIII–5 and –6, below.

35.87 percent of the stock. Chapter V discusses this concentration of management of accounts and assets in banks.[69]

As stated above, there is some evidence in Form I–8 data that plans are being managed in distinct accounts by more and different managers recently. In response to the question, "Has the employer replaced one or more of its outside investment managers or hired such a manager for the first time within the past 5 years?", 59 of the 135 plans reported "Yes." Of course, this may simply represent switching of accounts around or spreading them out among the same group of managers, but the growth in numbers of investment adviser managed accounts shown in response to the more detailed questionnaires,[70] suggests that some of this is attributable to switching in manager type.

Seventy-five of the 106 companies responding to Form I–8 reported having more than one separately managed account. Analysis of the response to the question when the account was first placed with present manager, reveals that in 33 cases (44 percent) the oldest account also is the largest, in 15 cases (20 percent) the largest account is at least as old as any smaller account, while in 27 cases (36 percent) the largest account is younger than the oldest account. While these numbers include the insured accounts, which tended to be older, they still suggest that firms tend not to terminate a management relationship, but rather tend to establish new secondary relationships, and that the newer managers do not tend initially to get the largest share of the firm's total pension-benefit plan business.

There also was evidence in the response to Form I–8 to support recent assertions that plans are becoming increasingly alert to the investment return on their accounts. One hundred and ten out of 135 plans responded "Yes" to the question, "Does the employer attempt to measure the 'performance' of any of the plan's manager(s)?" Fifty-five used a person or firm not associated with the employer or the manager to evaluate or supervise the plan's manager. For the most part these outside evaluators were brokerage firms, although a few actuarial consulting firms were identified. Cross tabulation of the response on whether investment return is measured or attempted to be measured reveals that of the 253 bank managed accounts, 232 were of plans answering "YES"; all 35 of the investment adviser managed accounts were from plans answering "YES"; while 19 of the 27 self-managed accounts were from plans answering "YES."

In general, use of outside actuarial firms appears to be limited primarily to the calculation of actuarial assumptions to be used for the plan, with under five percent of the accounts in the stage-two sample reporting that their plan used such firms for review of managers. A more significant secondary role appears to lie in assisting the employer in selecting a funding mechanism for the plan. See Table VIII–4, parts (A) and (B), below.

The annual rates of return assumed by the actuarial calculations of the plans whose accounts were in the second-stage sample generally

[69] See ch. V.E.

[70] The stage two sample had 15 investment adviser managed accounts in 1969, only four in 1964.

were modest, with only 15 percent of all accounts belonging to plans assuming a rate of return in excess of five percent per annum. In general, profit-sharing plans do not require or use such assumptions, while pension plans do. Among the pension plan accounts, bank managed accounts tend to belong to plans having lower assumed rates of return, 49 percent of the accounts belonging to plans assuming 4 percent per annum or lower, while less than 27 percent of the investment adviser managed accounts fell in this range. See Table VIII–5, parts (A) and (B), below.

One of the questions in the stage-two questionnaires sought to elicit the extent to which employer contributions for a given period were related to the investment results of the plan. Respondents were asked to choose the best answer from among the following alternatives:

Employer contributions for a given period are: (1) a fixed percentage of payroll; (2) variable according to investment results of the plan; and (3) variable but unrelated to investment results of the plan.

Although great caution should be exercised in interpreting the results of this question, summarized in Table VIII–6, parts (A) and (B), below, as the Study feels that respondents may not have responded consistently, it would appear that investment adviser managed accounts belong to plans for which contributions vary in relation to investment results to a greater extent than accounts managed elsewhere. This would suggest that investment adviser management is selected by those employers who are striving most urgently for increased return.

Three further characteristics of the stage-two sample accounts may be considered to be related to the general level of awareness of employers to their plans' investment activity: (1) the extent of the authority for investment decisions given the account manager, (2) the frequency of review of the account by the manager and the frequency of detailed reporting to the employer, and (3) the extent to which the employer designates the brokerage commissions generated by the account's trading.

Table VIII–7, parts (A) and (B), below, present the responses to the question on degree of investment authority. It should be noted that all account managers had investment authority or they would not have been designated as the account manager on Form I–8.

Table VIII–8, parts (A) and (B), below, shows the results of the question on frequency of review by the manager, while Table VIII–9, parts (A) and (B), below, shows the frequency with which detailed reports are given. It would appear that, in general, detailed reports are given less frequently than accounts are reviewed. Table VIII–10, parts (A) and (B), below, shows the results of the Study's question on designation of brokerage commissions by the pension-benefit plan client. These figures support the findings of Part Three of the Study that investment adviser managed account clients designate significantly larger percentages of commissions than bank managed account clients. Note that for present purposes, the question was considered to be not applicable to self-managed accounts, although it would be possible to

treat them as 100 percent designated accounts. If this is done, the total "Not Applicable" percentage drops to 6.08 percent, while the "More than 85%" figure rises to 15.97 percent, more than doubling the percentage of accounts over which employers designate more than 85 percent of commissions.

One of the questionnaires, Form I-20, sought information on legal and policy restrictions on particular types of investment practices. In many cases a complete answer would have required extensive legal research and still the correct response might have been subject to doubt. Most respondents provided well-thought out answers, but because of the subjective nature of many of the responses, most of these data are not susceptible of quantified presentation. One of the exceptions to this statement is the question concerning legal or policy restrictions on the holding of securities issued by a party in interest, which generally would be the employer corporation's stock. Respondents were requested to grade restrictions based in law, policy and contract separately. The Study then selected the most restrictive of these three answers as the overall response of an account. These responses are summarized on Table VIII-11, parts (A) and (B), below, which reveals that over 40 percent of all accounts responding were entirely prohibited from holding securities issued by a party in interest and that under 15 percent of the accounts had no restrictions on such holdings. When pension plan accounts are compared with profit-sharing plan accounts, it is apparent that the latter are under significantly fewer restrictions on this type of holding.

One of the written responses supplied in answer to the question on policy restrictions regarding holdings of securities issued by a party in interest underscores concerns felt by many regarding this activity:

> Holding securities issued by the respondent or a party in interest. It is our understanding that the law permits this type of activity but would require the specific approval of the IRS. The respondent's policy is to prohibit this type of activity in order to avoid questions of conflict of interest, questions of unfair use of insider information or that the purchase or sale of such securities by the respondent's pension fund might have an unduly favorable or unfavorable effect on those securities in the market place.

Concerns regarding investments in particular issuers other than a party in interest also are underscored in the written answer of a respondent.

> Holding securities of issuers in particular industries. It is respondent's policy to prohibit the purchase of securities of . . . customers, or potential customers,

of . . . the respondent. We believe this is necessary in order to avoid unfairness between customers. We do not feel it would be fair, for example, for the respondent's pension fund to finance in any way a part of one customer's business and not that of another. It is also our policy not to invest in the securities of . . . competitors in order to avoid any possible antitrust questions that might be raised. Since there are almost unlimited alternative investments available, we do not feel that the prohibitions in these areas are detrimental to the investment performance of the fund.

Because of recent concern over the degree of vesting of benefits in employees prior to retirement,[71] the Study sought information from respondents which would permit the classification of plans into early, intermediate or late vesting groups.[72] These results are set forth in Table VIII-12, parts (A) and (B), below.

Griffin and Trowbridge found that 27.3 percent of all plans were "Early" vesting, 41.9 percent "Intermediate" and 30.8 percent "Late." [73] The differences between the Study's results and the Griffin/Trowbridge results suggest that large plans tend to provide for early vesting to a greater extent than plans generally. Also, it should be noted that profit-sharing plans vest earlier in a greater proportion than pension plans.

Finally, in a question that has more relevance to Part Four of the Study, a question was asked concerning the passing through of voting authority over company stock held in the account. Table VIII-13, parts (A) and (B), below, gives the results. Again, significant difference exists between pension plans and profit-sharing plans, the latter pass through some voting authority 70 percent of the time, while the former do so less than ten percent of the time.

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[71] See sec. B.5.d, above.

[72] The Study used essentially the same criteria for these classifications as those used by Griffin and Trowbridge in their recent book, *Status of Funding Under Private Pension Plans*, that is—

Early vesting: Full vesting after 10 (or fewer) years of service.
Intermediate vesting: Full vesting after 11 to 20 years of service.
Late vesting: Full vesting after 21 years or more of service.

Where vesting is stated in terms of age rather than service, the age requirement minus 30 is substituted for the service requirement.

Where *both* service and age requirements must be met, the longer of the two is used.

Where *either* of two alternate vesting requirements is specified, the shorter is assumed.

Where vesting occurs gradually over a period of time, vesting is treated as if equivalent to full vesting at the midpoint of the period.

[73] *Id.* at 40.

TABLE VIII-4, PART (A)
CORPORATE PENSION-BENEFIT PLANS
USE OF OUTSIDE ACTUARIAL FIRMS

(PERCENT OF TOTAL ACCOUNTS)

ACCOUNT TYPE	NUMBER OF ACCOUNTS	NOT USED	FOR CALCULATIONS ONLY	CALCULATIONS AND CHOICE OF MEDIUM	CALCULATIONS AND REVIEW OF MANAGER	OTHER
Bank-Managed >0 ≤25	52	25.00	62.50	12.50	0.00	0.00
>25 ≤50	33	0.00	71.52	28.48	0.00	0.00
>50 ≤100	48	10.63	68.54	21.04	0.00	0.00
>100 ≤200	50	13.55	63.55	18.13	2.19	2.19
>200 ≤300	22	10.45	73.64	10.45	5.45	0.00
>300	20	15.00	80.00	5.00	0.00	0.00
Bank-Managed Total	225	13.41	67.98	17.05	1.02	0.49
Investment-Advisor Managed	16	6.25	56.25	25.00	12.50	0.00
Self-Managed	22	36.36	31.82	18.18	13.64	0.00
Total	263	14.89	64.25	17.63	2.77	0.42

TABLE VIII-4, PART(B)
CORPORATE PENSION-BENEFIT PLANS
USE OF OUTSIDE ACTUARIAL FIRMS

(PERCENT OF TOTAL ASSETS)

ACCOUNT TYPE	NUMBER OF ACCOUNTS	NOT USED	FOR CALCULATIONS ONLY	CALCULATIONS AND CHOICE OF MEDIUM	CALCULATIONS AND REVIEW OF MANAGERS	OTHER
BANK-MANAGED	193.5	0.62	78.47	19.26	1.19	0.57
INVESTMENT ADVISER-MANAGED	15.0	0.00	60.00	26.67	13.33	0.00
SELF-MANAGED	17.0	17.65	41.18	23.53	17.65	0.00
MANAGED PROFIT-SHARING	22.5	89.78	4.89	4.89	0.00	0.00
UNMANAGED PROFIT-SHARING	15.0	100.00	0.00	0.00	0.00	0.00
TOTAL	263.0	14.89	64.25	17.63	2.77	0.42

TABLE VIII-5, PART (A)
CORPORATE PENSION-BENEFIT PLANS
ACTUARIALLY ASSUMED ANNUAL RATE OF RETURN
(PERCENT OF TOTAL ACCOUNTS)

Account Type	Number of Accounts	0%	>0≤3.5%	>3.5%≤4.0%	>4.0%≤4.5%	>4.5%≤5.0%	>5.0%
Bank-Managed:							
> 0≤25	52	25.00	25.00	25.00	12.50	12.50	0.00
>25≤50	33	0.00	0.00	56.97	14.24	28.48	0.00
>50≤100	48.0	10.63	15.83	15.83	21.04	21.04	15.83
>100≤200	50	11.35	22.71	18.13	18.13	18.13	11.35
>200≤300	22	10.45	31.82	5.45	10.45	0.00	42.27
>300	20	15.00	25.00	10.00	5.00	5.00	40.00
Bank-Managed Total	225	12.92	19.54	22.96	14.96	16.03	13.59
Investment-Adviser Managed	16	6.25	6.25	18.75	18.75	31.25	18.75
Self-Managed	22	40.91	0.00	13.64	13.64	4.55	27.27
Total	263	14.86	17.10	21.92	15.08	16.00	15.05

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TABLE VIII-5, PART (B)
CORPORATE PENSION-BENEFIT PLANS
ACTUARIALLY ASSUMED ANNUAL RATE OF RETURN

(PERCENT OF TOTAL ACCOUNTS)

Account Type	Number of Accounts	0%	>0≤3.5%	>3.5%≤4.0%	>4.0%≤4.5%	>4.5%≤5.0%	>5.0%
Bank-Managed	193.5	0.00	22.72	26.69	17.40	17.45	15.80
Investment Adviser-Managed	15.0	0.00	6.67	20.00	20.00	33.33	20.00
Self-Managed	17.0	23.53	0.00	17.65	17.65	5.88	35.29
Managed Profit-Sharing	22.5	89.78	0.00	0.00	0.00	10.22	0.00
Unmanaged Profit-Sharing	15.0	100.00	0.00	0.00	0.00	0.00	0.00
Total	263.0	14.86	17.10	21.92	15.08	16.00	15.05

TABLE VIII-6, PART (A)

Corporate Pension-Benefit Plans
Contributions Relation to Investment
Results of the Plan
(Percent of Total Accounts)

Account Type	Number of Accounts	Contributions are a Fixed Percent of Payroll	Contributions Vary According To Plan Results	Contributions Vary not According to Plan Results
Bank-Managed:				
$>0 \leq 25$	52	50.00	37.50	12.50
$>25 \leq 50$	33	28.48	56.97	14.24
$>50 \leq 100$	48	21.04	42.08	36.88
$>100 \leq 200$	50	56.77	34.06	9.16
$>200 \leq 300$	22	73.64	10.45	15.91
>300	20	55.00	30.00	15.00
Bank-Managed Total	225	44.94	37.26	17.76
Investment Adviser Managed	16	12.50	68.75	18.75
Self-Managed	22	31.82	18.18	50.00
Total	263	41.87	37.58	20.52

TABLE VIII-6, PART (B)
Corporate Pension-Benefit Plans
Contributions Relation to Investment
Results of the Plan
(Percent of Total Accounts)

Account Type	Number of Accounts	Contributions are a Fixed Percent of Payroll	Contributions Vary According To Plan Results	Contributions Vary not According to Plan Results
Bank-Managed	193.5	46.00	42.75	11.31
Investment Adviser-Managed	15.0	13.33	73.33	13.33
Self-Managed	17.0	35.29	23.53	41.18
Managed Profit-Sharing	22.5	48.89	4.89	45.78
Unmanaged Profit-Sharing	15.0	14.00	0.00	85.33
Total	263.0	41.87	37.58	20.52

TABLE VIII-7, PART (A)

CORPORATE PENSION-BENEFIT PLANS

INVESTMENT AUTHORITY OF ACCOUNT MANAGER[1/]

(PERCENT OF TOTAL ACCOUNTS)

Account Type	Number of Accounts	Sole Investment Authority	Authority for Day-to-Day Within Guideline	Seldom Overruled But Must Consult Before Trades
Bank-Managed:				
>0≤25	52	100.00	0.00	0.00
>25≤50	33	56.97	42.73	0.00
>50≤100	48	84.20	15.80	0.00
>100≤200	50	77.29	13.55	9.16
>200≤300	22	73.30	20.81	5.43
>300	20	65.00	35.00	0.00
Bank-Managed Total	225	79.55	17.79	2.57
Investment Adviser Managed	16	43.75	25.00	31.25
Self-Managed	22	18.18	50.00	31.82
Total	263	72.25	20.92	6.76

1/ Investment Department for self-managed.

TABLE VIII-7, PART (B)
CORPORATE PENSION-BENEFIT PLANS
INVESTMENT AUTHORITY OF ACCOUNT MANAGER[1/]

(PERCENT OF TOTAL ACCOUNTS)

	Number of Accounts	Sole Investment Authority	Authority for Day-to-Day Within Guideline	Seldom Overruled But Must Consult Before Trades
Bank-Managed	193.5	81.54	16.09	2.42
Investment Adviser-Manager	15.0	46.67	26.67	26.67
Self-Managed	17.0	17.65	47.06	35.29
Managed Profit-Sharing	22.5	64.89	24.89	9.33
Unmanaged Profit-Sharing	15.0	50.67	42.00	6.67
Total	263.0	72.25	20.92	6.76

1/ Investment Department for self-managed.

TABLE VIII-8, PART (A)
CORPORATE PENSION-BENEFIT PLANS 1/
FREQUENCY OF ACCOUNT REVIEW BY MANAGER

(PERCENT OF TOTAL ACCOUNTS)

Account Type	Number of Accounts	Daily 2/	Weekly	Monthly	Quarterly	Annually	Other
Bank-Managed:							
>0≤25	52	62.50	0.00	12.50	25.00	0.00	0.00
>25≤50	33	28.48	14.24	14.24	42.73	0.00	0.00
>50≤100	48	47.50	42.08	0.00	10.63	0.00	0.00
>100≤200	50	40.84	20.52	9.16	24.90	0.00	4.38
>200≤300	22	68.64	15.91	10.45	5.45	0.00	0.00
>300	20	50.00	5.00	5.00	20.00	10.00	10.00
Bank-Managed Total	225	48.98	17.63	8.44	22.16	0.89	1.87
Investment Adviser Managed	16	43.75	43.75	12.50	0.00	0.00	0.00
Self-Managed	22	36.36	40.91	18.18	0.00	0.00	4.55
Total	263	47.61	21.16	9.50	18.96	0.76	1.98

1/ Investment Department for Self-Managed.
2/ Includes "Continuously."

TABLE VIII-8, PART (B)
CORPORATE PENSION-BENEFIT PLANS 1/
FREQUENCY OF ACCOUNT REVIEW BY MANAGER

(PERCENT OF TOTAL ACCOUNTS)

Account Type	Number of Accounts	Daily 2/	Weekly	Monthly	Quarterly	Annually	Other
Bank-Managed	193.5	46.41	19.93	9.29	22.82	0.00	1.60
Investment Adviser-Managed	15.0	46.67	40.00	13.33	0.00	0.00	0.00
Self-Managed	17.0	35.29	41.18	17.65	0.00	0.00	5.88
Managed Profit-Sharing	22.5	65.33	9.33	4.44	20.44	0.00	0.00
Unmanaged Profit-Sharing	15.0	51.33	13.33	6.67	7.33	13.33	7.33
Total	263.0	47.61	21.16	9.50	18.96	0.76	1.98

1/ Investment Department for self-managed

2/ Includes "continuously."

TABLE VIII-9, PART (A)
CORPORATE PENSION-BENEFIT PLANS
FREQUENCY OF DETAILED REPORTS

(PERCENT OF TOTAL ACCOUNTS)

Account Type	Number of Accounts	Daily	Weekly	Monthly	Quarterly	Semi-Annually	Annually	Other
Bank-Managed:								
>0≤25	52	0.00	0.00	12.50	62.50	0.00	12.50	12.50
>25≤50	33	0.00	0.00	14.29	85.71	0.00	0.00	0.00
>50≤100	48	0.00	0.00	26.32	57.89	5.26	5.26	5.26
>100≤200	50	0.00	0.00	45.45	43.18	0.00	11.36	0.00
>200≤300	22	0.00	5.26	47.37	47.37	0.00	0.00	0.00
>300	20	0.00	0.00	55.00	40.00	0.00	5.00	0.00
Bank-Managed Total	225	0.00	0.53	30.20	57.15	1.11	6.97	4.00
Investment-Adviser Managed	16	0.00	0.00	37.50	37.50	25.00	0.00	0.00
Self-Managed	22	4.55	0.00	50.00	22.73	9.09	4.55	9.09
Total	263	0.38	0.46	32.29	53.08	3.23	6.34	4.18

TABLE VIII-9, PART (B)
CORPORATE PENSION-BENEFIT PLANS
FREQUENCY OF DETAILED REPORTS

(PERCENT OF TOTAL ACCOUNTS)

Account Type	Number of Accounts	Daily	Weekly	Monthly	Quarterly	Semi-Annually	Annually	Other
Bank-Managed	193.5	0.00	0.62	28.45	62.21	1.29	8.11	0.00
Investment Adviser-Managed	15.0	0.00	0.00	33.33	40.00	26.67	0.00	0.00
Self-Managed	17.0	5.88	0.00	52.94	17.65	11.76	5.88	5.88
Managed Profit-Sharing	22.5	0.00	0.00	43.56	40.44	0.00	0.00	15.56
Unmanaged Profit-Sharing	15.0	0.00	0.00	40.67	7.33	0.00	0.00	43.33
Total	263.0	0.38	0.46	32.29	53.08	3.23	6.34	4.18

TABLE VIII-10, PART (A)
CORPORATE PENSION-BENEFIT PLANS
DESIGNATION OF BROKERAGE COMMISSIONS
(PERCENT OF TOTAL ACCOUNTS)

Account Type	Number of Accounts	Commissions Not Designated	Less Than 15%	15% to 85%	More Than 85%	Not Applicable
Bank-Managed:						
>0≤25	52	62.50	12.50	0.00	0.00	25.00
>25≤50	33	28.48	28.48	28.48	14.24	0.00
>50≤100	48	52.60	10.60	21.00	15.80	0.00
>100≤200	50	70.32	6.77	15.94	6.77	0.00
>200≤300	22	84.16	0.00	15.84	0.00	0.00
>300	20	75.00	5.00	10.00	5.00	5.00
Bank-Managed Total	225	60.38	11.27	14.64	7.41	6.21
Investment Adviser Managed	16	12.50	18.75	37.50	18.75	12.50
Self-Managed	22	0.00	0.00	0.00	0.00	100.00
Total	263	52.43	10.78	14.81	7.48	14.43

TABLE VIII-10, PART (B)

CORPORATE PENSION-BENFIT PLANS

DESIGNATION OF BROKERAGE COMMISSIONS

(PERCENT OF TOTAL ACCOUNTS)

Account Type	Number of Accounts	Commissions Not Designated	Less Than 15%	15% to 85%	More Than 85%	Not Applicable
Bank-Managed	193.5	59.72	11.91	13.98	8.10	6.70
Investment Adviser-Managed	15.0	13.33	20.00	40.00	13.33	13.33
Self-Managed	17.0	0.00	0.00	0.00	0.00	100.00
Managed Profit-Sharing	22.5	50.22	10.22	21.33	4.44	13.33
Unmanaged Profit-Sharing	15.0	65.33	0.00	7.33	6.67	20.67
Total	263.0	52.73	10.78	14.81	7.48	14.43

TABLE VIII-11, PART (A)
CORPORATE PENSION-BENEFIT PLANS
HOLDING OF SECURITIES ISSUED BY A PARTY IN INTEREST
LEGAL OR POLICY LIMITATIONS

(PERCENT OF TOTAL ACCOUNTS)

Account Type	Number of Accounts	No Policy or Silent	Permitted No Restriction	Permitted Subject to Restriction	Entirely Prohibited
Bank-Managed:					
0 25	45.5	0.00	0.00	57.14	42.86
25 50	33.0	0.00	0.00	85.71	14.29
50 100	48.0	5.26	21.05	26.32	47.37
100 200	50.0	0.00	2.27	45.45	52.27
200 300	21.0	0.00	11.11	38.89	50.00
300	20.0	15.00	10.00	35.00	40.00
Bank-Managed Total	217.5	2.54	7.16	48.18	42.12
Investment-Adviser Managed	16.0	6.25	12.50	37.50	43.75
Self-Managed	20.0	0.00	25.00	40.00	35.00
Total	253.5	2.58	8.90	46.86	41.66

TABLE VIII-11, PART (B)
CORPORATE PENSION-BENEFIT PLANS
HOLDING OF SECURITIES ISSUED BY A PARTY IN INTEREST
LEGAL OR POLICY LIMITATIONS

(PERCENT OF TOTAL ACCOUNTS)

Account Type	Number of Accounts	No Policy or Silent	Permitted No Restriction	Permitted Subject to Restriction	Entirely Prohibited
Bank-Managed	186.0	2.43	7.21	44.36	46.00
Investment Adviser-Managed	15.0	6.67	6.67	40.00	46.67
Self-Managed	15.0	0.00	13.33	40.00	46.67
Managed Profit-Sharing	22.5	0.00	8.92	64.45	26.63
Unmanaged Profit-Sharing	15.0	6.69	27.84	65.46	0.00
Total	253.5	2.58	8.90	46.86	41.66

TABLE VIII-12, PART (A)

Corporate Pension-Benefit Plans

Vesting Status of Plans

(Percent of Total Accounts)

Account Type	Number of Accounts	Early Vesting	Intermediate Vesting	Late Vesting
Bank-Managed:				
>0≤25	52	50.00	37.50	12.50
>25≤50	33	57.14	28.57	14.29
>50≤100	48	47.37	47.37	5.26
>100≤200	50	45.45	45.45	9.09
>200≤300	22	52.63	31.58	15.79
>300	20	65.00	35.00	0.00
Bank-Managed Total	225	51.04	39.27	9.68
Investment Adviser Managed	16	50.00	43.75	6.25
Self-Managed	22	31.82	45.45	22.73
Total	263	49.37	40.06	10.57

TABLE VIII-12, PART (B)
Corporate Pension-Benefit Plans
Vesting Status of Plans

(Percent of Total Accounts)

Account	Number of Accounts	Early Vesting	Intermediate Vesting	Late Vesting
Bank-Managed	193.5	44.89	45.61	9.49
Investment Adviser-Managed	15.0	46.67	46.67	6.67
Self-Managed	17.0	23.53	47.06	29.41
Managed Profit-Sharing	22.5	85.27	4.46	10.27
Unmanaged Profit-Sharing	15.0	85.33	6.67	8.00
Total	263.0	49.37	40.06	10.57

TABLE VIII-13, PART (A)

CORPORATE PENSION-BENEFIT PLANS
PASSING THROUGH OF VOTING AUTHORITY OVER
COMPANY STOCK TO PLAN BENEFICIARIES
(PERCENT OF TOTAL ACCOUNTS)

Account Type	Number of Accounts	Voting Authority Never* Passed Through	Voting Authority Always Passed Through	Voting Authority Sometimes Passed Through
Bank-Managed:				
$>0 \le 25$	52	75.00	25.00	0.00
$>25 \le 50$	33	100.00	0.00	0.00
$>50 \le 100$	48	94.79	5.21	0.00
$>100 \le 200$	50	90.84	4.58	4.58
$>200 \le 300$	22	89.55	5.45	5.45
>300	20	90.00	10.00	0.00
Bank-Managed Total	225	89.17	9.33	1.55
Investment Adviser-Managed	16	100.00	0.00	0.00
Self-Managed	22	81.82	13.64	4.55
Total	263	89.21	9.12	1.71

* Includes cases where company stock not held.

TABLE VIII-13, PART (B)
CORPORATE PENSION-BENEFIT PLANS
PASSING THROUGH OF VOTING AUTHORITY OVER
COMPANY STOCK TO PLAN BENEFICIARIES
(PERCENT OF TOTAL ACCOUNTS)

Account	Number of Accounts	Voting Authority Never* Passed Through	Voting Authority Always Passed Through	Voting Authority Sometimes Passed Through
Bank-Managed	193.5	99.48	0.62	0.00
Investment Adviser-Managed	15.0	100.00	0.00	0.00
Self-Managed	17.0	88.24	11.76	0.00
Managed Profit-Sharing	22.5	40.44	44.44	14.67
Unmanaged Profit-Sharing	15.0	20.00	72.00	7.33
Total	263.0	89.21	9.12	1.71

* Includes cases where company stock not held.

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