

# Regulatory and Operational Issues for US Advisers Investing Overseas

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**I**n today's market, investment advisers increasingly are directing their focus abroad toward investments in foreign securities. Although changes in global investing and trading over the last decade have resolved many of the problems that plagued advisers in the 1990s, investing in foreign securities still can raise investment, regulatory, and operational concerns that can go overlooked until problems occur. This article surveys some of the principal concerns in this area.

## Limits on Foreign Ownership

Some foreign countries restrict foreign ownership of local companies generally or in the case of certain industries. For instance, until 2002, India banned foreign investment in print media and tea plantations (now foreign investors can purchase up to 26 percent of media companies and 100 percent of tea plantations). Even if foreign investors are permitted to invest in local companies, many countries still require that foreign investors purchase "foreign" shares, reserving "local" shares for trading by local residents or impose lockup periods for holdings of local shares. For example, for now, in China, foreign investors are heavily restricted from buying Yuan-denominated A shares unless the foreign investors are designated as Qualified Foreign Institutional Investors (a designation that has been granted sparingly), and can only buy foreign currency—denominated B shares. However, new regulations published on December 31, 2005 may open up the market for A shares of Chinese companies to foreign investors.<sup>1</sup>

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## Disclosure and Limits of Foreign Ownership

Even if foreign investors are permitted to invest in local companies, many countries require that foreign investors report their local company investments. In Southeast Asia, for example, the Malaysian government requires firms to disclose the name, address, taxpayer identification number, and citizenship of each investor in Malaysian companies. Foreign investors who wish to invest in South Korean companies must apply for approval before investing. Upon the submission of required information and the opening of necessary accounts, final approval will be granted by the Financial Supervisory Service (FSS) with the issuance of an investment registration card. Foreign investors conducting transactions in South Korean companies must do so in the name listed on the investment registration card, thus enabling the government to monitor all securities transactions by foreign investors. Korea also limits ownership by foreign investors of certain companies (*e.g.*, Korea Electric Power Corp., for which foreign ownership is limited to 40 percent in the aggregate and 3 percent for any single foreign investor) as well as specific industries (*e.g.*, listed aviation companies, for which foreign ownership is limited to 49.99 percent). Finally, once various investment thresholds are attained in Korea (as well as other foreign countries), a foreign investor must file threshold holding reports with designated governmental authorities.

## Foreign Licensing or Qualification Requirements

Some countries require foreign investors to register before investing. For example, in India, foreign investors are required to register as “Foreign Institutional Investors” with the Securities and Exchange Board of India and to obtain approval from the Reserve Bank of India to enable them to buy and sell securities, open foreign currency and Rupee bank accounts, and remit and repatriate funds. Similarly, in Taiwan, certain foreign institutional investors are required to complete an application to the Taiwan Stock Exchange Corporation to qualify as a Foreign Institutional Investor or FINI. Any company undertaking such a qualification process must apply for investment approval with the Taiwanese authorities through a local agent. The local agent’s role is to open accounts with local brokers, report foreign exchanges, exercise voting rights, pay taxes, and file tax returns.

## Trading and Settlement Concerns

Trading foreign securities can pose a greater risk of trade errors and other operational and

regulatory problems than trading US securities. These added risks stem primarily from differences in trading practices, processes and rules, but other factors contribute to these added trading risks as well.

## A Case of Mistaken Identity

Foreign securities are more prone to misidentification in the course of a trade. Foreign companies may have multiple classes of securities trading, including “foreign” and “local” shares. Moreover, foreign issuers often have confusingly similar names. Inadequate understanding of a foreign company’s capital structure or imprecision in placing orders to foreign brokers can result in an adviser’s purchasing the wrong securities, as well as consequent valuation, settlement, and other problems.

## Complications of “Physical” Markets

While many foreign countries have transitioned from physical to book-entry markets, some countries still have physical markets that require delivery of properly endorsed share certificates to effect trades. Consequently, the settlement process can be lengthy (and erratic in some markets) and carries an increased risk of fails and counterfeiting (historically a problem in India and Pakistan). Also, the use of bearer shares is more common in some countries, which leads to the increased risk of theft. As a result, there has been a pronounced shift in many foreign countries toward dematerializing securities and the corresponding increase in use of securities depositories.

## Non-DVP Transactions

Local trading and settlement customs in a number of foreign countries (including Russia, Ukraine, Jordan, Zimbabwe, Cyprus, and Ivory Coast) frequently call for non-DVP (delivery versus payment) transactions. Unlike DVP transactions, which involve a simultaneous exchange of securities and payment, non-DVP transactions can increase counterparty risk and create an environment ripe for speculation because the purchaser pays before securities are delivered or the seller delivers securities before payment is made.

## Trading Days and Hours

Differences in trading days and hours can also create operational and regulatory problems. For

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*The Investment Lawyer* (ISSN 1075-4512) (USPS P0000-062) is published monthly for \$410 per year, \$697 for two years, \$984 for three years, and a single issue is \$41 by Aspen Publishers, at 76 Ninth Avenue, New York, NY 10011. Postmaster: Send address changes to *The Investment Lawyer*, Aspen Publishers Distribution Center 7201 McKinney Circle, Frederick, MD 21704.

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example, unforeseen foreign trading holidays created difficulties for some US mutual funds in the 2001 holiday season when they sought to compute NAV or sell securities to honor redemption requests. Differences in trading hours can lead to trade allocation issues where, for instance, an adviser places a trade in an Asian market at the close of business in the United States and then allocates the trade after receiving an execution report the next morning—well after the securities have continued trading—resulting in a clear profit or loss on the trade.

### **Risks of Cross-Border Settlement**

Cross-border settlements raise special risks because they involve interaction of different settlement systems and laws in different countries. These risks include operational risks, legal risks, principal risks in foreign exchange transactions (called “Herstatt” risks in reference to the failure of the Bankhaus Herstatt to meet its foreign exchange obligations in 1974), and liquidity risks. Legal risks arise from differences in laws in the affected countries, including choice and conflict of laws issues that can cause uncertainty regarding such matters as finality of transfer, ownership interests, or collateral rights (which can complicate the use of collateral to mitigate credit exposures). Differences in bankruptcy laws can also result in uncertain or conflicting outcomes regarding the disposition of securities in the event of insolvency of a counterparty or an intermediary.<sup>2</sup>

### **Investment Restrictions**

Investing in foreign securities may also raise compliance issues with client-imposed and legal investment restrictions, possibly including the need to classify the foreign securities as restricted or illiquid under client investment restrictions because of the illiquidity of the foreign market or restrictions on the transferability of the foreign securities.

### **Investment Company Act Restrictions**

Investing in foreign securities by mutual funds may trigger restrictions under the Investment Company Act of 1940 (Investment Company Act). For example, Section 12(d)(1) limits a mutual fund’s investments in other mutual funds or investment companies. Foreign companies not usually considered to be “investment compa-

nies” may hold significant investments in other companies and thus may meet the Investment Company Act’s definition of “investment company.” Similarly, Section 12(d)(3) prohibits mutual funds from investing in companies engaged in the business as a broker, dealer, underwriter, or US registered adviser except as permitted under Rule 12d3-1. Rule 12d3-1 imposes certain percentage limits on a mutual fund’s investments in these kinds of companies, but excludes from those limits companies that derive no more than 15 percent of their gross revenues from securities-related activities. Foreign banks and other companies engaged in securities-related activities are more likely than their US counterparts to exceed the 15 percent threshold.

Section 10(f) prohibits a mutual fund from purchasing securities during the existence of an underwriting syndicate when an affiliated person of the fund is a member of that syndicate. Rule 10f-3 excepts from Section 10(f)’s general prohibition purchases in “eligible foreign offerings” and “eligible Rule 144A offerings.” An eligible foreign offering is a public offering of securities that is conducted under the laws of a foreign jurisdiction and regulated by a foreign authority, where the securities are offered at a fixed price to all purchasers and the issuer’s financial statements for the two-year period before the offering are available publicly and to prospective purchasers. An eligible Rule 144A offering is an offering of securities sold in transactions exempt from registration under the Securities Act of 1933 to persons the seller reasonably believes to be QIBs.

Finally, mutual funds are required to fair value securities when market prices for those securities are not readily available. This undertaking can become more complicated with certain foreign securities for which there is no meaningful proxy for the local foreign security (*e.g.*, NYSE-listed American Depositary Shares) or in situations in which the foreign company has a relatively small capitalization structure, or its shares are infrequently or thinly traded.

### **OFAC Restrictions**

Special considerations also include restrictions under the Trading with the Enemy Act and other laws administered by the US Treasury Department’s Office of Financial Assets Control (OFAC). OFAC regulations prohibit US persons from investing in companies in certain embargoed countries. Violations of the investment

embargoes can result in substantial civil and criminal penalties.

### **State Investment Restrictions**

State laws may limit the extent to which investment advisers can invest state pension or retirement plan money in foreign securities, particularly securities of companies that conduct business with certain embargoed countries. For example, earlier this year, Illinois effectively imposed a ban on the investment of Illinois state retirement system or state pension fund assets in any Sudanese company or other company that has business contacts with the Sudan. Several other states (such as New Jersey and Oregon) have approved divestment plans or have pending Sudan divestment legislation.<sup>3</sup>

### **Trading Restrictions**

Foreign jurisdictions or markets may restrict or limit certain kinds of trading or treat certain trading as manipulative activity subject to anti-fraud rules. For example, various foreign countries—including at last count China, Colombia, Greece, Pakistan, South Korea, Venezuela, and Zimbabwe—do not allow short sales. The principal Malaysian stock exchange, Bursa Malaysia Bhd, does not currently allow limited short selling of stocks (but may do so in the near future).<sup>4</sup>

### **Custodial Risks**

Foreign requirements and the practicalities of trading through foreign brokers often will dictate that foreign funds and securities be held with foreign custodians. Maintaining custody abroad poses special risks.

### **Use of Ineligible Foreign Custodians**

Trading practice or pragmatics in foreign markets may lead advisers to place their clients' funds or securities with foreign brokers that may not be eligible custodians for client assets. This situation may arise, for example, when an adviser delivers cash or securities to a foreign broker well before settlement (such as in a non-DVP transaction) or has foreign shares held in a foreign broker's name while the broker works an order to minimize custodial transfer charges (a practice sometimes called "warehousing"). For mutual funds, delivering fund cash or securities to brokers that are not eligible foreign custodians raises issues under

Section 17(f) of the Investment Company Act and Rules 17f-5 and 17f-7, which regulate the manner in which a mutual fund may place and maintain its foreign assets with a foreign custodian or foreign securities depository. For other advised accounts, maintaining client funds or securities with a foreign custodian (such as a foreign prime broker) that commingles proprietary and client funds may not satisfy the requirements of the Investment Advisers Act of 1940 custody rule, Rule 206(4)-2, unless, among other things, the foreign custodian maintains a separate account for each advisory client (under the client's name) or a separate account for the assets of the adviser's clients (under the adviser's name as agent or trustee for the clients).<sup>5</sup>

### **Custodial Discrepancies**

For various reasons, a US custodian's records may differ from its foreign subcustodian's records for the same security. These discrepancies can result from settlement errors, the foreign subcustodian's failure to report distributions received to the US custodian or the possibility that the two custodians use different pricing services to value the securities. For a mutual fund, these discrepancies can lead to situations in which the fund's NAV is miscalculated.

### **Higher Costs**

Maintaining custody of foreign assets abroad can be more expensive than maintaining custody of domestic assets in the United States.

### **Investment Risks**

Investments in foreign securities carry special risks, including vulnerability to foreign market volatility, changes in foreign exchange rates, and foreign political, economic, and social events—all of which may be more pronounced in emerging markets. The SEC has prepared an online publication for investors, *International Investing: Get the Facts*, <http://www.sec.gov/pdf/ininvest.pdf>, which provides an excellent overview of the risks of investing in foreign securities.

### **Less Regulation & Haphazard Enforcement**

Many countries do not regulate issuers, stock markets or securities to the extent the United States does. In addition, even if regulations are on the books in a particular foreign country, the

foreign country may not enforce the regulations or may do so haphazardly. The *Far Eastern Economic Review* quoted one Chinese trader nearly a decade ago as saying, “there are lots of regulations, but no one minds them.”<sup>6</sup> Although the regulatory climate shows signs of improvement, a few years ago the president of a US investments company branded the business climate in Russia as “jungle capitalism” after a Russian company failed to repay a \$6 million loan (as ordered by a Russian court) and Russian officials refused to intervene unless they received 20 to 50 percent of the proceeds.<sup>7</sup> However, a number of countries have established corporate governance standards to bolster investor confidence in their capital markets. In addition, while minority shareholder rights are not as well established in many foreign countries as in the United States, some countries (such as Brazil) have recently taken steps to remedy this situation.

### **Less Information**

Many foreign companies do not give investors the same types of information as US public companies do. The limited information available may not be current or in English. On the other hand, over the past decade more and more foreign private issuers have become reporting companies under the Securities Exchange Act of 1934 (689 as of June 21, 2005),<sup>8</sup> and in May 2002 the SEC adopted rule changes requiring foreign private issuers and foreign governments to file their securities documents electronically through EDGAR, increasing access to those materials. The trend of foreign private issuers’ becoming reporting companies has slowed considerably because of the phase-in of foreign private issuers being subject to Section 404 of the Sarbanes-Oxley Act, which requires a company to include in its annual reports a report by management on the company’s internal control over financial reporting and an accompanying auditor’s report. The SEC has twice extended the compliance date for Section 404, which is now scheduled to come into effect for any foreign private issuer on its first fiscal year ending on or after July 15, 2006.

### **Manipulation and Speculation**

Insider trading and front-running are permitted in some foreign countries, although a number of countries (including Brazil, Mexico, New Zealand, and Singapore) adopted laws and regulations in the past five years to combat insider

trading and other manipulative conduct. Also, the structure of some foreign countries’ markets may create opportunities for speculation, either because of non-DVP transactions or because local investors can arbitrage between “local” and “foreign” shares. As a result, advisers may not be able to simply rely on company fundamentals to make investment decisions.

### **Limited Recourse**

A US investor may not be able to sue a foreign issuer or foreign broker in the United States. Even if a US investor succeeded in US courts, the investor might not be able to enforce the judgment against the foreign defendant because US courts generally will not have jurisdiction over the foreign defendant and because foreign courts generally will not recognize judgments of US courts for liabilities predicated on US federal securities laws. The only remedy available to a US investor may be whatever legal remedies are available in the issuer’s or broker’s home country, and these remedies may be limited.

### **Non-Tradable Shares**

Investors that seek to invest in certain “state-owned” Chinese companies need to be aware of rather large potential holdings of those companies’ shares by the Chinese Government. Certain shares historically have been owned by the Chinese Government are not tradable in order to ensure continued Government ownership. This ownership, in turn, has caused concerns among investors, not the least of which would be the effect on tradable shares should the Government decide to allow the non-tradable shares to be freely traded on the exchanges. In 2005, the China Securities Regulatory Commission (CSRC) commenced a plan to merge non-tradable and tradable shares of Chinese state-owned companies so that all shares could be freely traded on the stock exchanges. The plan was eventually extended to all listed companies. Companies that have sought to merge their tradable and non-tradable shares have done so in large part by compensating shareholders of tradable shares with a form of bonus shares or warrants by shareholders of nontradable shares.

### **US Tax Issues**

Investments in foreign securities may trigger application of IRS rules relating to passive foreign investment companies (PFICs). Generally, a foreign

company is treated as a PFIC when at least half of its asset value or three-quarters of its income in any year is from certain “passive” sources, which include debt securities and derivatives. For a US investor, holding shares in a PFIC can result in substantial additional tax (reflecting the recharacterization of capital gains as ordinary income, which is subject to a higher tax rate and the imposition of an interest charge) on the receipt of dividends or proceeds from the sale of shares. The adverse consequences of selling shares in, or receiving dividends from, a PFIC do not apply if a US investor makes a “qualified electing fund” election.

## Foreign Tax Issues

Investing overseas may also trigger foreign tax requirements if the adviser is conducting business in a foreign jurisdiction. This was punctuated when the South Korea National Tax Service slapped hundreds of millions of dollars in taxes on five foreign funds operating in the country after conducting an investigation.<sup>9</sup>

## Proxy Voting

Voting proxies for foreign securities may involve greater effort and corresponding cost due to the variety of regulatory schemes and corporate practices in foreign countries. For example, proxy materials may be written in a foreign language, and some countries provide little or no notice of shareholder meetings (for example, often only two weeks notice for Japanese issuers holding their annual general meetings). Some countries effectively require personal presence to vote at meetings (Italy, Belgium and Sweden) and restrict foreign investors’ ability to vote (Finland, Norway, the Netherlands, and Germany, especially when the shares are held in the name of a nominee).

To vote in some countries, the foreign custodian or depository must “block” the securities within a specified number of days before the shareholder meeting. Once blocked, securities typically may not be traded or transferred until a day or two after the meeting. Advisers sometimes refrain from voting shares of foreign securities subject to blocking restrictions when they believe the need for liquidity outweighs the benefit of voting.

The SEC and the Department of Labor (DOL) have recognized the challenges of voting foreign proxies in their respective guidance on proxy voting. For example, in its release adopting the Advisers Act proxy voting rule, Rule 206(4)-6, the SEC observed that there “may even be times when

refraining from voting a proxy is in the client’s best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client” and went on to note that “casting a vote on a foreign security may involve additional costs such as hiring a translator or traveling to the foreign country to vote the security in person.”<sup>10</sup> Similarly, in the DOL’s Interpretive Bulletin 94-2,<sup>11</sup> the DOL explained that plan fiduciaries should consider the cost of voting proxies both when deciding to invest in foreign securities in the first place and when deciding (on a cost-benefit basis) whether to vote foreign proxies in individual cases.

## Bribery Issues

Investment advisers conducting business abroad should also be mindful of the antibribery provisions of the Foreign Corrupt Practices Act (FCPA). The FCPA’s antibribery provisions make it unlawful for any issuer, domestic concern, or person acting in the United States to corruptly make or offer a payment of anything of value directly or indirectly to a foreign official, international organization official, political party or party official, or any candidate for public office for the purpose of influencing any official act to assist in obtaining or retaining business. Indirect payments include those made by foreign agents on behalf of a company if the company knowingly participates in or authorizes the payments. FCPA issues can arise in a variety of circumstances, including in connection with payments to foreign “consultants” well placed to obtain foreign licenses, payments of solicitation fees with respect to seeking foreign governmental clients, and, in some cases, the establishment of joint ventures with foreign governmental officials.<sup>12</sup>

## Know Your Stuff

To address the investment, operational and regulatory challenges of foreign investing, advisers should inform themselves about the foreign markets in which they invest and trade and monitor changes (such as adverse market events, fraudulent schemes and problem brokers). Good sources of information include US custodians and brokers with international businesses. Additional information is available from the International Organization of Securities Commissions, <http://www.iosco.org>, and the International Securities Services Association, <http://www.issanet.org>. The Bureau of National Affairs, Inc. (BNA) publishes

a monthly report, *World Securities Law Report*, [www.bna.com](http://www.bna.com), which also covers developments in foreign investing.

## NOTES

1. See Ministry of Commerce, China Securities Regulatory Commission, State Administration of Taxation, State Administration for Industry and Commerce and State Administration of Foreign Exchange, “Administrative Measures Concerning Strategic Investment of Foreign Investors in Listed Companies” (Dec. 31, 2005).
2. See Asian Development Bank, “Bond Market Settlement and Emerging Linkages in Selected ASEAN+3 Countries” (June 2005), at Ch. 3, available at <http://www.adb.org/Documents/Reports/ASEAN-Plus-3/>.
3. See Catherine Saadeh, “Illinois’ Sudan Ban Goes Into Effect; Other States Following Suit,” *IM Insight News* (February 6, 2006); The Sudan Divestment Task Force, “The State of Sudan Divestment,” Dec. 24, 2005; updated Mar. 31, 2006), available at <http://www.sudandivestment.com/sudandivestment.pdf>.
4. See Arturo Bris, William N. Goetzmann & Ning Zhu, “Short-Sales in Global Perspective” (Dec. 9, 2003 Draft), avail-

able at <http://faculty.som.yale.edu/~ab364/ssglobal.pdf>; Arturo Bris, William N. Goetzmann & Ning Zhu, “Efficiency and the Bear: Short Sales and Markets around the World” (Jan. 2003), available at <http://www.sec.gov/spotlight/hedgefunds/hedge-efficiency.pdf>; Morgan Stanley Global Network Management—Short Selling Details—Equities (Mar. 27, 2003), available at <http://www.oecd.org/dataoecd/5/14/318465550.pdf>; “Malaysia to Allow Short-Selling,” *Wall St. J.*, Mar. 24, 2006, at C12.

5. See ABA Subcommittee on Private Investment Entities, SEC Staff No-Action Letter (Dec. 8, 2005), at I.L.C. Question 1.
6. Pamela Yatsko, “Never Mind the Rules,” *Far Eastern Economic Review*, Feb. 13, 1997.
7. See Sharon Theimer, “U.S. to Russia: Clean Corruption Up,” *The Associated Press*, July 31, 2002.
8. See SEC, “List of Foreign Issuers That Have Submitted Information Under the Exemption Relating to Certain Foreign Securities” (June 21, 2005), <http://www.sec.gov/rules/other/34-51893.pdf>.
9. See “South Korean Probe Uncovers Tax Evasion by Five Foreign Funds,” *Dow Jones Newswires*, Sept. 30, 2005; Laura Santini, “Lone Star Pledges to Pay Korean Tax on Sale of Bank,” *Wall St. J.*, Apr. 19, 2006, at C4.
10. See *Proxy Voting by Investment Advisers*, Advisers Act Release No. 2106 (Jan. 31, 2003), available at [http://www.sec.gov/rules/finallia-2106.htm#P75\\_15255](http://www.sec.gov/rules/finallia-2106.htm#P75_15255).