Compliance Corner

Regulatory and Operational Considerations for U.S. Advisers Investing Abroad

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In November 2008, the Organization for Economic Co-Operation and Development released its estimates for growth in the major economies for 2009 and 2010, confirming what many U.S. investment advisers had suspected for months - most of Europe, the U.S. and New Zealand will likely experience a sustained recession, while China and India will experience growth rates from 6% - 8% and Indonesia, Russia, Brazil, and South Africa will experience somewhat lower growth rates. Not surprisingly, U.S. investment advisers increasingly are directing their focus abroad to take advantage of potential investment opportunities in foreign countries with growing economies. Although changes in global investing and trading over the last decade have resolved many of the problems that plagued advisers in the early 1990s, investing in foreign markets still can raise investment, operational and regulatory concerns that can go overlooked until problems occur. Below we survey some of the principal concerns in this area.

Limits on Foreign Ownership and Governmental Screening Requirements

Some foreign countries restrict foreign ownership of local companies generally or within certain industries. Based upon the Organization for Economic Co-Operation and Development's 2007 Foreign Direct Investment Regulatory Restrictiveness Index, the countries that remain the most restrictive with respect to foreign direct investment include Russia, India, and China. For instance, in May 2008, Russia's President Vladimir Putin signed legislation restricting foreign investment in 42 sectors of the economy that are defined as "strategic" and requires foreign investors to apply for and receive permission from a government commission to obtain more than a 49% stake in a Russian company in most of those sectors. For investment in companies that are involved in sectors important for national security, such as mineral oil or gas, governmental permission is required for obtaining an interest greater than 10%. Even when foreign investors are permitted to invest in local companies, many countries still require that foreign investors meet restrictive qualification and registration requirements or purchase only certain classes of shares. 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. While, in China, foreign investors are heavily restricted from buying Yuan-denominated A shares unless they are registered as *"Qualified Foreign Institutional Investors"* (a designation that has been granted to only 65 foreign investors as of August 2008), although foreign investors may buy foreign currency-denominated B shares, while Chinese investors may trade either class of shares.

Reporting Requirements of Foreign Ownership Interests

Even if foreign investors are permitted to invest in local companies after receiving governmental approval, many foreign countries require foreign investors to periodically report their ownership interest in local companies. For example, 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 with the issuance of an investment registration card. South 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 for specific industries (e.g., listed aviation companies, for which foreign ownership is limited to 49.99 percent). Finally, once various investment thresholds are

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attained in South Korea (as well as other foreign countries), a foreign investor must file threshold holding reports with designated governmental authorities.

Trading, Clearance and Settlement Concerns

Trading foreign securities can present a greater risk of trade, clearance and settlement problems and other regulatory issues than trading U.S. securities. These additional risks stem primarily from differences in trading practices, processes and rules, but other factors contribute to heightened trading risks. First, foreign securities may be more prone to misidentification in the course of a trade. Foreign companies may have multiple classes of securities trading or confusingly similar names. Inadequate understanding of a foreign company's capital structure or imprecision in placing orders to foreign brokers can also result in an adviser purchasing the wrong securities – and consequent valuation, settlement and other problems. Second, while many foreign countries have transitioned from physical to book-entry markets, some countries still have physical markets requiring 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). Third, differences in trading days and hours can also create operational and regulatory problems. Differences in trading hours can lead to trade allocation issues where, for instance, an adviser places a trade in Asian markets at the close of business in the U.S. and then allocates the trade after receiving an execution report the next morning – well after the securities have continued trading and results in a clear profit or loss on the trade. Finally, cross-border settlements raise special risks because they involve interaction of different settlement systems and laws in different countries, from choice and conflict of laws issues to bankruptcy laws.

Investment Restrictions

Investing in foreign securities may also raise compliance issues with client-imposed and legal investment restrictions, including the possible 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 companies" 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 U.S. 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% of their gross revenues from securities-related activities. Foreign banks and other companies engaged in securities-related activities are more likely than their U.S. counterparts to exceed the 15% threshold. Finally, Section 10(f) prohibits a mutual fund from purchasing securities during the existence of an underwriting syndicate where 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, 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 qualified institutional buyers ("QIBs").

Restrictions based upon U.S. Foreign Policy and National Security Interests – Special considerations also include restrictions on investments in certain foreign countries and companies based upon federal and state laws designed to further U.S. foreign policy and national security goals. For example, the Office of Foreign Assets Control ("OFAC"), which is part of the U.S. Treasury Department, administers and enforces economic and trade sanctions programs against

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targeted foreign countries, terrorists, international narcotics traffickers and those engaged in activities related to the proliferation of weapons of mass destruction. U.S. investment advisers must comply with the requirements of OFAC that generally prohibit investments in particular jurisdictions or with specially designated nationals as identified on lists published on OFAC's website ("OFAC Lists"). Similarly, state laws may limit the extent to which investment advisers may invest state pension or retirement plan money in foreign securities, particularly securities of companies that conduct business with countries identified on OFAC Lists. For example, 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. Many other states (including New Jersey and Oregon) have approved divestment plans or have pending Sudan divestment legislation.

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, Columbia, Greece, Pakistan, South Korea, Venezuela, and Zimbabwe – do not allow short sales. Given the recent turbulence of the global securities markets, additional countries – including at last count Austria, Australia, Belgium, Canada, Denmark, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, Norway, Pakistan, Portugal, Singapore, Spain, Switzerland, U.S. and U.K. - have adopted temporary rules designed to prohibit "naked" shorting of financial stocks, increased disclosure requirements for short sales, and/or established penalties for failed delivery.

Custodial Issues

Foreign requirements and the practicalities of trading through foreign brokers will often 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, where 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.

Custodial Discrepancies – For various reasons, a U.S. custodian's records may differ from its foreign sub-custodian's records on the same security. These discrepancies can result from settlement errors, the foreign sub-custodian failing to report distributions received to the U.S. 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 where the fund's NAV is miscalculated.

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, that 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 of U.S. regulation. 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. For example, in July 2007, the Financial Times

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reported that many participants in Indonesia's Jakarta Stock Exchange, the third best performing Asian market during 2007, believe that stock prices are manipulated. The World Bank, in a report on Indonesia's non-bank financial institutions, stated "Based on independent assessments, the enforcement of transparency, information disclosure and corporate governance are still weak in Indonesia's equity market [and] administrative sanctions for violation are particularly inadequate. Limited and unclear powers of the securities regulator also lead to significant shortcomings in its ability to oversee the markets, supervise market participants and enforce issuer compliance." However, a number of countries (including China in 2005 and India in 2007) 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 U.S., some countries (such as Brazil) have taken steps to remedy this recently.

Less Information – Many foreign companies do not give investors the same types of information as U.S. public companies do. The limited information available may not be current or in English. On the other hand, some foreign private issuers have become reporting companies under the Securities Exchange Act of 1934 (1,230 as of January 1, 2007), and since the SEC adopted rule changes requiring foreign private issuers and foreign governments to file their securities documents electronically through EDGAR, access to those materials has increased. However, the trend since the phase-in of foreign private issuers being subject to Section 404 of the Sarbanes-Oxley Act of 2002, which requires significant disclosure in their annual reports, is for foreign private issuers to exit the U.S.

Manipulation and Speculation – Insider trading and front running are permitted in some foreign countries, although a number of those countries are moving towards adopting laws and regulations to combat insider trading and other manipulative conduct. For example, on December 1, 2008, Vladimir Milovidov, the head of Russia's Federal Financial Markets Service, indicated that the Russian government approved laws to restrict insider trading and create a compensation fund for victims of investment fraud that will be presented for approval by Russia's parliament next year. 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 U.S. investor may not be able to sue foreign issuers or foreign brokers in the U.S. Even if a U.S. investor succeeded in U.S. courts, the investor might not be able to enforce the judgment against the foreign defendant because U.S. courts generally will not have jurisdiction over the foreign defendant and because foreign courts generally will not recognize judgments of U.S. courts for liabilities predicated on U.S. federal securities laws. The only available remedy may be whatever legal remedies are available in the home country for foreign investors and these remedies may be limited.

U.S. and Foreign 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 are from certain "passive" sources, which include debt securities and derivatives. For a U.S. 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 U.S. investor makes a "qualified electing fund" election.

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 in September 2005.

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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 notice of shareholder meetings (*e.g.*, Denmark provides 8 days prior notice; Germany provides a month's prior notice). Some countries require personal presence to vote at meetings (*e.g.*, to vote against management requires personal attendance in Belgium). In other countries, the foreign custodian or depository must "block" the securities within a specified number of days before the shareholder meeting (*e.g.*, Austria, Belgium, Greece, Italy, Portugal, Poland, Hungary, and Spain). Once blocked, securities typically may not be traded or transferred until the day or two after the meeting. Advisers sometimes refrain from voting shares of foreign securities subject to blocking restrictions where they believe the need for liquidity outweighs the benefit from voting. The Department of Labor ("DOL") has recognized the challenges of voting foreign proxies in its guidance on proxy voting. Most recently, the DOL clarified in Interpretive Bulletin 08-2 that "If the responsible fiduciary reasonably determines that the cost of voting (including the cost of research, if necessary, to determine how to vote) is likely to exceed the expected economic benefits of voting, or if the exercise of voting results in the imposition of unwarranted trading or other restrictions, the fiduciary has an obligation to refrain from voting."

Prohibitions on Payments to Foreign Officials

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 an 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. Significantly, the Department of Justice ("DOJ") has more recently been prosecuting private equity investors. For example, in *United States v. Omega Advisors, Inc.*, the DOJ took action against the hedge fund Omega Advisors, Inc. that was a major investor ($100 million) in an investment scheme managed by Czech investment promoter Viktor Kozeny. Kozeny allegedly sought to secure investments from a consortium of institutional and individual investors and to use the funds to make improper payments to officials to secure the right to invest in the anticipated privatization of the State Oil Company of Azerbaijan ("SOCAR"). Omega Advisors, Inc. entered a non-prosecution agreement with DOJ in 2007, which required forfeiture of $500,000 and cooperation with authorities in prosecuting other institutional investors. Thus, the government has made clear that U.S. investors who own or control a foreign entity are at risk of FCPA enforcement.

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 U.S. 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. Bureau of National Affairs, Inc. (BNA) publishes a monthly report, *World Securities Law Report,* www.bna.com, which also covers developments in foreign investing.

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