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INTRODUCTION

It was only after increased investment in foreign-based mutual funds by the German public that the Federal Republic of Germany attempted to regulate the sale of these funds in its territory. The West German government, upon the submission of its regulatory proposal to the Bundestag, noted that "[t]he importance and bulk of these [foreign-based mutual fund] distributions [had] reached an order of magnitude that

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1The net capital outflow from Germany resulting from purchases of investment trust certificates rose from an average of $8 million in the period 1961-63 to $40 million in 1966 and then to $240 million in 1968. ORGANIZATIONS FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (hereinafter cited as OECD), COMMITTEE FOR INVISIBLE TRANSACTIONS, The Capital Market, International Capital Movements, Restrictions on Capital Operations in Germany 30 (1969). This growth is perhaps best illustrated by the record of Bernard Cornfeld's Investors Overseas Services Ltd. (SA) (I.O.S.) which sold $4.8 million (face amount) in investment contracts in West Germany in 1964 and $257 million in 1969. RAW, PAGE & HODGSON, DO YOU SINCERELY WANT TO BE RICH? 188-89 (1971). Of course, only a portion of the face amount of these contracts would be paid immediately, and after sales loads, even less would go into assets under management. For a brief discussion of the attractiveness of the German market to I.O.S. salesmen see id. at 185-87.

2Domestic investment institutions (Kapitalanlagegesellschaften), managing funds and selling fund units had been regulated since 1957 by The Investment Institutions Act, Law of April 16, 1957, [1957] BGBI. 1 378 [Gesetz uber Kapitalanlagegesellschaften vom 16 April 1957] (hereinafter cited as the 1957 Investment Company Statute). This Act was amended and recodified in 1970 ([1970] BGBI. I/127) and all references will be to the Act as amended. For a brief general discussion of the Statute see TORMANN, THE INVESTMENT INSTITUTIONS 19-30 (English ed. 1965).
[made] legislative initiative action necessary." It was noted further that "the coexistence of domestic investment companies, which must observe the provisions of a strong protective statute in the interest of the investor, and foreign companies, which are not even subject to a comparable statute in their home countries, can lead to serious disturbance in the competitive relations between the two groups."

In the summer of 1972, observing that "recent developments in this field have not been entirely painless," the Committee on Financial Markets of the Organization for Economic Co-operation and Development (OECD) proposed "Standard Rules for the Operation of Institutions for Collective Investment in Securities" which "it might be desirable for institutions to observe which operate in Member countries or which have access to residents of Member countries . . . to protect those residents who in their own Member country invest in securities of domestic and of foreign institutions for collective investment." The purpose of this article is to provide a framework for the compara-

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4Id.

5ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, COMMITTEE ON FINANCIAL MARKETS, STANDARD RULES FOR THE OPERATIONS OF INSTITUTIONS FOR COLLECTIVE INVESTMENT IN SECURITIES 9 (1972) [hereinafter cited as OECD Standard Rules]. The introduction to the OECD Standard Rules continues: "Sales of collective investment securities are frequently linked to complex long-term savings plans the real merits of which are not easy to judge. Promotion was sometimes unscrupulous and in such cases the mainspring for the success of the institutions for collective investment turned out to be a serious . . . weakness which did much harm to the reputation of the industry as a whole."

6OECD Standard Rules 10. The Committee on Financial Markets has announced that it "intends to watch the reactions to the standard rules of the collective investment industry, to review periodically the use to which they are being put or the extent to which they are being implemented and to consider the possibility of their improvement in the light of practical experience." OECD Standard Rules 11. See also the 34th and 35th Standard Rules and comments thereunder, OECD Standard Rules 51-52.

The OECD has by no means been the only international organization active in this area. On October 12, 1972, the Council of Europe published "European Rules for Investment Funds," recommending that Member States "make their laws and practice relating to investment funds conform with the [Council] rules . . . without prejudice to more favourable rules which may be laid down in the interest of participants." For the English text of these rules see 12 INT'L LEGAL MAT'LS 100 (1973). While the Council's rules are substantially similar, both in philosophy and in substantive detail, to the OECD Standard Rules, the latter are probably more significant since they are potentially applicable to major capital markets outside of Europe, viz. Japan and the United States.
tive and critical examination of the West German Statute Concerning the Distribution of Foreign Investment Shares and the Taxation of their Proceeds of 28 July 1969 and the OECD Standard Rules. The reference point for this framework is the United States Investment Company Act of 1940 which is not only the most pervasive of the regulatory schemes affecting collective investment institutions but also undoubtedly the scheme most familiar to most readers.

As with most marketing practice regulation, the history of the control of mutual fund sales consists very substantially of instances of locking the barn door after the horses have been stolen. The tendency is to deal ad hoc with abuses, either in the organizational structure and function of the fund entity itself or in the methods by which it is offered to the consuming public. Even in light of the observation that it is a part of the human condition that the ingenuity of the promoters may always run ahead of the imagination of the regulators, the transnational scope of mutual fund operations in recent years points up the potential value

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10In the legal and general literature concerning this subject the terms "investment company," "investment trust," "institution for collective investment" etc. have been used as generic identifications. The diversity in terminology undoubtedly results from the diversity in legal entity forms dealt with in foreign investment activities. In this article the term "mutual fund" will generally be used to describe any type of "institution for collective investment in securities." What the term lacks in precision it makes up in easy identification.
11Admittedly, this has been almost exclusively a one-way street. The Interest Equalization Tax Act, INT. REV. CODE of 1954, §§ 4911-21, 4931, 6011(d), 6076, 6680 and 7241, which became effective July 19, 1963, and is expected to extend at least through the end of 1973, effectively discourages any investment in foreign securities by a United States resident taxpayer by imposing a 11.25% tax on their acquisition (from foreigners) of the securities of foreign issuers. See particularly INT. REV. CODE of 1954, §§ 4920(a)(3)(B) and 4920(e). The attractiveness of the American securities trading markets has also been a substantial factor.

On April 3, 1973, the Securities and Exchange Commission submitted legislative proposals to Congress which would amend § 7 of the Investment Company Act of 1940 and Subchapter M of Chapter 1 of the INT. REV. CODE of 1954 to create a "Foreign Portfolio Sales Corporation" which
of drawing on comparative experiences in the formulation and construction of regulatory schemes.\textsuperscript{12} This article will identify a number of the areas in which the American experience with the Investment Company Act of 1940 has obviously been utilized in this process and will provide several suggestions as to the manner in which further contributions to the regulatory process might be drawn from comparative and empirical studies.

It is interesting to observe that at the same time that West Germany, and other European countries, and the OECD were engaged in broadening and developing standards for the regulation of mutual funds the United States was engaged in the substantial debate and controversy which resulted in the Investment Company Amendments Act of 1970.\textsuperscript{13} This article will discuss the relevant regulatory changes contained in these amendments and the problems with which they were intended to deal in the context of similar problems arising under the West German and OECD regulatory schemes.

\section*{I. AREAS OF REGULATORY IMPACT}

It is possible at this point to identify, albeit somewhat arbitrarily, fourteen key factors in the organization, management, and sale of mutual funds which seem to require, or have traditionally been subject to a certain amount of regulatory impact. These factors may be arranged, without reference to their importance, according to their relationship to the sale of mutual fund shares, the organization and operation of the fund itself, and the sale or redemption of shares.
Sale of Mutual Fund Shares

1) The disclosure of information, particularly that concerning investment policy, to the prospective buyer prior to the sale.
2) The “sales load,” *i.e.*, the size of the sales commission charged.
3) “Front end loading,” *i.e.*, the distribution of the sales charges over time in respect to investment plans requiring regular periodic payments.
4) The buyer’s right of rescission.

Organizational Structure of the Mutual Fund

5) The form of the entity, *i.e.*, trust account, corporate, or contractual.
6) The control by shareholders or unit holders:
   a) with respect to by-laws;
   b) with respect to investment policy; and
   c) with respect to management contracts and fees.
7) The existence and rights of different classes of securities and debts.

Investment Operations of the Mutual Fund

8) The time and method of the valuation of shares or fund units.
9) The independence of management in relation to:
   a) duty to shareholders;
   b) self-dealing and dealing with related parties.
10) The character of investments and investment policy—securities only? (publicly traded only?), real estate, short sales and hedge funds.
11) The size and computation of management fees—performance fees.

Redemption or Sale of Mutual Fund Shares by the Investor

12) The right of redemption—open- and closed-end funds.
13) The events which trigger the suspension of rights of redemption and the effects of such suspension.
14) The depository protections afforded the shareholders’ rights in fund assets.

There exists an additional factor in the regulation of mutual funds which is both a special creation of regulatory schemes and a major incentive, or disincentive, to the mutual fund investment decision. This is the domestic tax treatment of holders in respect to the fund’s distributed or undistributed income and appreciation. The second part of the
West German 1969 Foreign Investment Shares Statute substantially equalizes the treatment of the holders of shares of foreign-based funds which meet the requirements of the Statute or are traded on the West German stock exchanges with the treatment of the holders of shares of domestic mutual funds. This is perhaps a sugar-coating on the regulatory pill. The comparison and harmonization of tax regulation in respect to mutual fund investment is, however, beyond the scope of this inquiry, particularly since its impact on investor protection is necessarily minimal.

II. JURISDICTIONAL FOCUS

Before proceeding into a detailed analysis of the impact of the West German Statute and the Standard Rules on the above itemized factors it is necessary to describe the legal means by which the regulation of mutual funds is effected. If the fund entity and its management are domiciled within the regulating jurisdiction the matter of in personam control is easily solved. But the problem becomes more difficult if, as is by definition the case with “offshore” mutual funds, the contact with the jurisdiction is something less. Two principal types of activities within a jurisdiction which have been said to support the exercise of regulatory control over mutual funds and their management are 1) use of the domestic capital market mechanisms for effecting portfolio investment decisions and trades and 2) domestic sales activity.

The jurisdictional focus of the West German 1969 Foreign Investment Shares Statute at the entity level is not available domestically (as it is in the United States with Subchapter M of the INT. REV. CODE of 1954, §§ 851-855, and as it is in West Germany with § 38 of the 1957 Investment Company Statute) it is to be assumed that the fund entity will be formed and domiciled in a country which provides such (or greater) relief, i.e., a “tax haven” country.

*Compare 1969 Foreign Investment Shares Statute § 17 with id. § 18.*

The attractiveness of the American securities market has meant that a substantial amount of this activity has taken place within United States jurisdiction. The Securities and Exchange Commission has taken the position that such activity is sufficient to confer subject matter jurisdiction on United States courts, at least in respect to violations of the Securities Exchange Act of 1934. In the Matter of IOS, Ltd (SA), CCH Fed. Sec. L. Rep. ¶ 78, 637 at pp. 81, 360-61 (March 14, 1972), petition for Commission review pending. See also Memorandum of Plaintiff Securities and Exchange Commission in Support of Motion for Preliminary Injunction and Ancillary Relief in SEC v. Vesco, 72 Civ. 5001 (C.E.S.) (S.D.N.Y. filed November 27, 1972). It has also been suggested that use of the instrumentalities of interstate commerce in the United States when portfolio management, custodial and depository functions related to an offshore fund are performed in the United States may be sufficient to require registration by the fund under § 7(d) of the Investment Company Act of 1940, 15 U.S.C. § 80a-7(d) (1970). Remarks of Allan S. Mostoff, supra note 12 at 392-94. See also Treas. Reg. § 1.864-2(c) (iii) (1968); Investment Company Act Release No. 5618 (Feb. 25, 1969), CCH Fed. Sec. L. Rep. ¶ 77,671 [1967-1969 Transfer Binder].
ment Shares Statute is upon the sales activities of foreign-based mutual funds. Section 2 of the Statute outlines the basic conditions which must be satisfied if foreign-based mutual funds shares are to be distributed or sold in West Germany,\(^8\) and § 13(2) imposes a fine of up to 50,000 DM on any person who, willfully or negligently distributes foreign-based mutual fund shares when the notification,\(^9\) waiting period,\(^2\) and stop-order\(^2\) provisions of the Statute are violated. The Federal Supervisory Office for Credit Affairs (Bundesaufsichtsamt für Kreditwesen), which is charged with administration of the Statute,\(^2\) may also, by regulation, prohibit improper and misleading sales and promotion techniques\(^2\) and stop distribution of a foreign-based mutual fund’s shares if violations of these regulations persist after a warning from the Supervisory Office,\(^2\) even though the fund has complied with the other conditions of the statute.

The OECD Standard Rules are concerned both with domestic mutual funds organized in the regulating country\(^2\) and with “foreign institutions for collective investment that actively solicit and promote sales” in that country.\(^2\) The following comments of the Committee with respect to the 34th Standard Rule on Official Surveillance are relevant here:

The Committee considers that the supervisory authority of each member country must exercise a surveillance over all c.i.i.s. [institutions for collective investment in securities] established in their country.

It also feels that the supervisory authority of each member country must be free to take any measures they consider necessary to protect

\(^{11}\)1969 Foreign Investment Shares Statute § 2. Section 1 of the Statute limits its application to distributions “by means of public offers, public advertising, promotion or solicitation or similar means.” Private offerings, in the Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1970) sense, and such things as participations in investment partnerships thus presumably do not come under the statute.

Section 1(2) of the Statute excludes from coverage “foreign investment shares which are admitted for official trading on a German stock exchange so far as, with the exception of the publications required by the stock exchange, no distribution within the meaning of § 1(1) takes place.”

\(^{19}\)1969 Foreign Investment Shares Statute § 7(1).

\(^{21}\)Id. § 8(1).

\(^{21}\)Id. §§ 8(2), 10(2).

\(^{21}\)Id. § 14.

\(^{21}\)Id. § 10(1).

\(^{21}\)Id. § 10(2).

\(^{21}\)Domestic fund sales in West Germany are, of course, regulated by the 1957 Investment Company Statute. See TORMANN, supra note 1.

\(^{26}\)OECD Standard Rules 19.
the local participating investors of foreign c.i.i.s. The Swiss expert stressed, however, that supervision exercised outside the country in which a c.i.i. is established would necessarily be subsidiary and indirect (e.g., for checking accounts).

The Committee notes that it is possible for a c.i.i. to be organized under the laws of a Member country without the supervisory authority of that country having the power to oversee and control the activities of such c.i.i. unless the securities of the c.i.i. are sold domestically. In such a situation the Committee presumes that the supervisory authority of any Member country where these securities are publicly sold will exercise adequate official surveillance.27

The Committee also expressed the opinion that

[w]hen considering applications for admission from foreign institutions which comply with the standard rules, Member countries should give substantial weight to the fact of such compliance and within the general framework of the domestic regulations, compliance with any restrictive requirements might in such cases be liberally interpreted.28

Jurisdiction over foreign-based mutual funds has not, however, been limited to the control of sales-related activities within the regulating countries. Both the West German 1969 Foreign Investment Shares Statute and the OECD Standard Rules provide a basis for more pervasive supervision of the fund’s internal structure and operation through the requirement that a domestic agent be designated.29 Though the function of the designated agent is primarily that of the receipt of the service of legal process, it is clear that the designation of such an agent will subject both the fund’s full assets and its management to domestic sanctions.30

In this connection it is interesting to observe that the West German government rejected as “not practical” the theoretically simple means of regulating foreign-based mutual funds through subjecting them to the controls of the 1957 Investment Company Statute because the Federal

27OECD Standard Rules 51 (emphasis added and paragraph numbers omitted).
28OECD Standard Rules 11. It is understood that the Securities and Exchange Commission has agreed, at least informally, to follow this in its enforcement of § 7(d) of the Investment Company Act, 15 U.S.C. § 80a-7(d) (1940).
291969 Foreign Investment Shares Statute § 2(l), OECD Standard Rules 48 (30th Rule). The Statute states that the agent is to be a domestic bank or a “reliable, professionally suitable person,” whereas the Standard Rules provide only that the agent must be “acceptable to the supervisory authority.” It was thought in West Germany that to limit the role of agent to banks only, would be violative of constitutional equal opportunity provisions. Regierungsentwurf in BRÜCHER & PULCH, supra note 3, at 61.
Supervisory Office for Credit Affairs could not conduct the type of examination of "quality" to which the management and operation of a domestic mutual fund are subjected and because strict adherence to the domestic West German law might have been impossible when that law conflicted with similar provisions in the law of the jurisdiction in which the fund is organized or based. In contrast to the domestic regulatory scheme, "a concept for this [foreign investment shares] statute has been consciously chosen which will avoid the impression that a comprehensive investigation of good quality by German administrative authority has preceded the distribution" and which depends very substantially on disclosure of relevant information to the investor in order that he may arrive at his own conclusions as to the quality and appropriateness of his proposed investment.

III. PRIVATE ENFORCEMENT

Any regulatory scheme which relies on intelligent discrimination by the investment public based on the disclosure of relevant information must provide an effective means of assuring the accuracy and completeness of the information which is provided. If the regulating authority is to supervise this disclosure to any degree greater than satisfying itself that the fund has complied with the statutory minima it will soon find itself in a role that is substantially the same as making investigations of quality. Traditionally, when disclosure is the regulatory vehicle, the individual investor bears the burden not only of evaluating the information that is disclosed but also of assuring that the information is accur-

31Regierungsentwurf in BRÜCHER & PULCH, supra note 3, at 53.
33The question very obviously obviously arises: is the average West German investor in any better position than the Federal Supervisory Agency for Credit Affairs to make judgments about the quality of foreign-based investment shares being offered to him? Answering this in the negative still leaves unanswered the very basic question of the role of disclosure in the regulation of securities sales, more acute here, certainly, since investors in mutual fund shares may be apt to be less financially sophisticated than investors in common equity stocks. The contrast between West German regulation of domestic and foreign-based mutual fund offerings suggests an opportunity for empirical research into the effectiveness of the two types of regulatory schemes, unfortunately an opportunity as yet ignored. In the absence of empirical data, this article can only observe and focus upon the statutory limitations which are thought necessary, in addition to the requirements of disclosure and the statutory mechanism aimed at providing effective disclosure.

One suspects, nevertheless, that the omission of foreign-based mutual funds from the ambit of official Bonitatsprüfung is based more on considerations of administrative convenience than on faith in disclosure as the ultimate tool in securities regulation. For a discussion of some of the alleged inadequacies in disclosure material, as it has developed in practice under United States law see Kripke, The Myth of the Informed Layman. 28 Bus. Law. 631 (1973).
ate and complete, primarily through his right of rescission or by an action for damages when the information is either inaccurate or incomplete. Admittedly, in United States practice the investor may actually bear little of the burden since § 8(d) of the Securities Act of 1933 empowers the Securities and Exchange Commission to issue stop orders suspending registration, "if it appears to the Commission at any time that the registration statement includes any untrue statement of material fact or omits to state any material fact required to be stated therein or necessary to make the statement therein not misleading" and § 20(b) of the same Act authorizes the Commission to obtain injunctive relief in respect to violations of the securities laws generally. Under the West German 1969 Foreign Investment Shares Statute, however, incorrect or incomplete statements of a material nature in the notification statement or in the sales prospectus are among the specific grounds upon which § 8(3) of the Statute permits the Federal Supervisory Agency for Credit Affairs to prohibit the distribution of foreign investment shares. Thus the sanction against fraudulent, misleading, or omitted material information lies solely in the investor's right to rescission contained in § 12 of the Statute.

The OECD Standard Rules make no provision with respect to the investor's right of rescission, but they are, after all, minimum standards. The second Standard Rule provides that even though the sales prospectus, "which shall be available to the public, . . . shall be submitted to the supervisory authority before a [mutual fund] begins to operate" within the jurisdiction, the supervisory authority which is to "verify that it contains all the information required . . . will not approve its substance." In a regulatory scheme which thus places the burden of evaluation on the investor rather than on the regulator, it would appear to be a very serious omission, even from minimum standards, to fail to provide a mechanism, in addition to any local law of fraudulent misrepresentation, by which to insure the accuracy and completeness of the information.

The right of rescission under the West German law is, by American

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36Arguably, if the information contained in the sales prospectus is inaccurate or incomplete, the requirements of § 3 with respect to the contents of the sales prospectus have not been complied with and therefore the § 2(5) prerequisite to distribution is not satisfied. But once distribution has begun § 8(3) (2) requires the Supervisory Agency to prohibit further distribution when "a prerequisite pursuant to 2(1)-(4) has ceased to exist"!
37OECD Standard Rules 23 (emphasis added).
standards at least, severely limited. This right exists only against the mutual fund, its management company, or sales company. Directors, professional experts, and other persons are not liable for damages in a manner similar to that provided in § 11 of the Securities Act of 1933. While the maximum period of liability under the German law, extending for three years after a sale, is the same as that under the '33 Act, the German investor has but six months, rather than one year, in which to bring suit after the error or deficiency of the sales prospectus becomes known. A provision which is perhaps even more detrimental to the German investor's position is § 12(3) of the 1969 Foreign Investment Shares Statute which allows any company, including the issuer of the mutual fund shares, to escape liability for rescission if it "shows that it did not know of the incorrectness of the sales prospectus and the lack of knowledge was not based on gross negligence." While this section is to some extent patterned on § 12 of the Securities Act of 1933, the broader liabilities of § 11 of that Act, to which the issuer has not even a due diligence defense, have been ignored in the German law. The mutual fund's responsibility for its own statements is thus considerably less than absolute.

IV. INVESTMENT COMPANY DEFINED

Before itemizing the limitations that the regulatory schemes place on fund sales, structure, and operation it is important to note the entities which are identified as mutual funds, "institutions for collective investment in securities," and are thus subjected to these regulatory schemes.

The 1969 Foreign Investment Shares Statute applies to "funds [Vermögen] existing under foreign law" which are composed of securities or real estate and which are "invested pursuant to the principle of diversifying risk." The last-quoted phrase is a key one which the legis-

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30 Id.
31 1969 Foreign Investment Company Shares Statute § 12(5).
32 Id. § 12(3). Compare § 12(2) of the Securities Act of 1933 which exempts any person who "sustain[s] the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission."
34 1969 Foreign Investment Shares Statute § 1. In addition, this section of the Statute focuses on the public distribution of the shares of such funds.
lative history describes as "decisive" and notes further that "it is not only the shares of those funds which place the minimizing of all possible risk in the foreground which fall under the provisions. Rather the law is applicable also to growth funds for which the prime motive of investment policy is increasing value."45

The OECD Standard Rules apply to

an institution for collective investment in securities which, applying the principle of risk spreading, has as its object the management of a portfolio of securities; which distributes its shares to the public by issuing share certificates or entering the name of the participating investor in a register; and which is required upon the request of the participating investor to redeem directly or indirectly a share it has issued.46

The scope of the Standard Rules is therefore less ambitious than that of the German Statute in that it does not attempt to deal with real estate funds nor with closed-end funds. The German Statute deals with these funds by effectively prohibiting them, i.e., by requiring that the fund contract redeem its shares on demand by the shareholder.47 Since both regulatory schemes focus on intentional risk spreading through diversification, there is no possibility of obtaining an unintentional investment company status such as exists under the 40-per-cent-of-assets rule of § 3(a)(3) of the Investment Company Act of 1940.48 Neither of the schemes provides any further definition of diversification, such as the Investment Company Act formula for a "diversified" management company,49 though, as will be seen, both actively require diversification through restrictions on investment and ownership.50

Neither regulatory scheme expresses a preference for any particular form or legal entity nor distinguishes in any respect among mutual funds organized as corporations or as trusts or other contractual arrangements. The liberality of the OECD Standard Rules is completely understandable since they must cover a wide variety of jurisdictions which utilize differing organizational forms. Such liberality is noteworthy in the West German law, however, since domestically organized mutual funds sold in Germany must be held in the joint account form separate from its own assets and by a management company organized in the

45BRÜCHER & PULCH, supra note 3, at 59.
46OECD Standard Rules 21 (emphasis added).
471969 Foreign Investment Shares Statute § 2(4) (b).
50See pp. 244, 249-50 infra.
corporate form (Aktiengesellschaft or Gesellschaft mit beschränkter Haftung). Restrictions are placed on the transfer of stock in the management company and a supervising board of directors (Aufsichtsrat) is required whether the corporation is private or public. In contrast to domestic management companies, which must have minimum paid-in capital of 500,000 DM, foreign-based funds operating in Germany are not subject to even minimal capital requirements. If, as the legislative history indicates, the application of such restrictions is undesirable if it would eliminate from the German market “so far unobjectionably functioning investment companies which are domiciled in highly developed countries lacking investment supervision” the restrictions on domestic fund operations become increasingly difficult to justify.

V. REGULATORY IMPACT

With the jurisdictional and definitional focus of the regulatory schemes firmly in mind, it is now appropriate to discuss seriatim the specific regulatory handling of the key factors in mutual fund operations which have previously been identified.

A. Disclosure of Information to the Prospective Buyer

The 1969 Foreign Investment Shares Statute and the OECD Standard Rules and the United States statutes, contemplate the use of informational sales literature which is to be given to the purchaser or at least “available to the public.” Both list, to some extent, the items of information which are to be included, and the West German Statute

1957 Investment Company Statute §§ 1, 3.

Id. § 1(3)-(4).

Id. § 3.

Id. § 2(2). This theoretically assures solvency of the management company—there is no minimal fund size such as that contained in § 14 of the Investment Company Act of 1940, 15 U.S.C. § 80a-14 (1970). The OECD Standard Rules, in the 17th Rule, require a minimum capital in either the fund or its management company, “the equivalent of 100,000 to 125,000 units of account.” OECD Standard Rules 35.

Of course, just such disparity has been the principle encouragement to the creation and existence of “offshore” funds.

See pp. 218-20 supra.

A share of stock or other interest in an investment company is a security within the definition of § 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(1) (1970), and is thereby subject to the provisions of that Act, including § 5(b)(2), 15 U.S.C. § 77e(b)(2) (1970), requiring the delivery of a statutory prospectus (see § 2(10) and § 10) prior to or contemporaneously with the delivery of a security through the mails or in interstate commerce. Cf. Investment Company Act 1940 § 24, 15 U.S.C. § 80a-24 (1970).

1969 Foreign Investment Shares Statute § 3(1).

OECD Standard Rules 23 (2nd Rule).
is supplemented by guidelines promulgated by the Federal Supervisory Office for Credit Affairs.60

The OECD Standard Rules list the following items which are to be dealt with in the prospectus:
1. "A description of the general aims and objectives of the c.i.i.;"61
2. "information concerning its legal structure;"62
3. "an up-to-date financial statement which shows the size and distribution of the assets of the c.i.i., its operating expenses and the income distributed to the participating investors for each of the last three to five years;"63
4. "all material information on the individuals or legal entities responsible for the direction, management, investment advice trusteeship, custody of the portfolio and sale of the shares of the c.i.i.;"64
5. "the name and address of the agent through whom legal papers can be served upon the c.i.i.;"65
6. "the name of any major company with which the investment advisers might be associated;"66
7. a full explanation of "rates and methods of calculation of any sales and redemption charges and of the management fees and costs, as well as periods over which they will be levied;"67
8. "method and procedure of the valuation of the assets;"68
9. "the obligation [in the 7th Rule] to make available for publication and to any person, free of charge, the net asset value per share and the sales price per share and the redemption price per share [and] where and how this information may be obtained;"69
10. "how frequently calculations of the net asset value, the sales price and the redemption price shall be made."70

Section 3(2) of the 1969 Foreign Investment Shares Statute initially

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61OECD Standard Rules 23 (2nd Rule).
62Id.
63Id.
64Id. at 24 (3rd Rule).
65Id.
66Id. (4th Rule).
67Id. (19th Rule).
68Id. at 27 (7th Rule).
69Id. at 42 (25th Rule).
requires that the prospectus contain "all declarations which are of substantial meaning in the judgment [of the quality] of the foreign investment shares." With the exception of the sixth and the tenth items, each of the ten items listed in the OECD Standard Rules is also specifically required by the Statute, with the slight variation that only the most recent annual financial statement (supplemented by a semi-annual statement if it is more than nine months old) is required. A further minor exception is that only the name or trade name, legal form, domicile, and equity capital of the persons described in the fourth item are specifically required.

Moreover, the Statute specifically requires that the prospectus describe "the prerequisites and conditions under which the holders of the shares may demand the payment of the portion of the fund which is allocable to the share as well as the offices authorized for such purposes." The prospectus must also contain "an explanation of the right of the purchaser to rescind" in addition to "an express statement that the foreign investment company is not subject to governmental supervision by a German agency.

The absence of the tenth item from the requirements of the German statute is obviated by the fact that the sales price and the price of redemption of the foreign-based mutual fund shares must be published continuously at least once a week in the Bundesanzeiger and daily in a newspaper of general circulation identified in the prospectus and having a place of publication within the geographical area of the distribution of the shares. The apparent omission of the sixth item, while seemingly of only marginal importance, becomes substantially significant, however, when viewed against the comment of the OECD Committee of Financial Market that it "intended to help reveal conflicts of interests and other details of the portfolio managers' and investment advisers'  

\[\text{1969 Foreign Investment Shares Statute § 3(2) (translation by this writer). Less literally, Brücher & Pulch, supra note 3, at 19 translates the phrase as "all information which is of material importance for judging the foreign investment shares. . . ."}\]

\[\text{1969 Foreign Investment Shares Statute §§ 3, 4(1)(1). Certified financial reports for the past three years are to be submitted to the Federal Supervisory Office. Regs. of Aug. 26, 1969, para. 4.1, see note 60 supra.}\]

\[\text{id. § 3(2)(6).}\]

\[\text{id. § 3(2). Specific language that will satisfy these latter two requirements is contained in paras. 15.10 and 15.9 respectively of Regs. of Aug. 26, 1969.}\]

\[\text{1969 Foreign Investment Shares Statute § 4(1)(3).}\]

\[\text{To the extent that such information is "of substantial meaning in the judgment of the foreign investment shares" it is of course subject to that general requirement. See pp. 228-29 supra.}\]
activities. The omission is perhaps not surprising since conflicts of interest affecting the activities on behalf of the mutual fund by the management fund or its investment advisers are completely unregulated by the 1969 Foreign Investment Shares Statute.

The information in the prospectus logically most important to the average investor will be the description of the general aims and objectives of the fund. The investor must be cognizant of whether the fund is, among other things, a growth fund, an income fund, a growth-income fund, an aggressive growth fund, or a balanced fund. The requirements of the 1969 Foreign Investment Shares Statute are rather general in this respect, but are roughly similar to the requirements of § 8(b)(1)-(3) of the Investment Company Act of 1940. It seems clear that a prospectus description meeting the requirement of the Investment Company Act and the Securities Act of 1933 in this respect would also pass muster under the German laws and regulations.

B. Size of the Sales Commission Charged

The drafters of the OECD Standard Rules, unwilling "to formulate a rule limiting the amount of . . . [management] fees and [sales and redemption] charges," required only that "the participating investor should be in a position, however, to find out how much he is paying and for what." The 1969 Foreign Investment Shares Statute is consistent
with this view, operating apparently on the assumption that disclosure\textsuperscript{8} will enable this factor to be controlled by the forces of competition. Domestic mutual fund sales commissions and fees are likewise unregulated, but apparently have averaged about 3.5 percent of the net asset value per share,\textsuperscript{87} whereas foreign-based funds, such as the IOS International Investment Trust, have charged commissions in West Germany of up to 8.5 percent, an amount equal to approximately 9.3 percent of the amount actually invested.\textsuperscript{88} No fiduciary or other duty which might prevent excessive sales loads is imposed on the management of foreign-based funds.\textsuperscript{89}

Recent experience in the United States is very relevant here. Prior to the 1970 amendments, § 22(b) of the Investment Company Act prohibited sales loads or commission charges which were "unconscionable or grossly excessive."\textsuperscript{90} This section now requires that the public offering price of investment company securities "shall not include an excessive sales load but shall allow for reasonable compensation . . . ."\textsuperscript{91}

The Securities and Exchange Commission's initial proposal in this respect would have limited sales commissions to five percent\textsuperscript{92} of the amount invested, in contrast to the generally prevailing rate of 9.3 percent. A version submitted in the House of Representatives would have created a presumption that the sales charge was fair and equitable if it had been approved within a year by a two-thirds vote of the outstanding shares and all of the unaffiliated directors.\textsuperscript{93} This is not the place to discuss in detail the relative merits of these different control standards, nor even to outline the abuses or potential abuses which made the 1970 changes appropriate.\textsuperscript{94} It is sufficient for present purposes to

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\textsuperscript{8} Required by 1969 Foreign Investment Shares Statute § 3(2)(5).

\textsuperscript{87} TORMANN, supra note 2, at 26.

\textsuperscript{88} RAW, PAGE & HODGSON, supra note 1, at 196. The IIT commission scaled down to 2.5 percent on single investments of $1 million or more. Id.

\textsuperscript{89} Nor are excessive sales loads dealt with in the 1957 Investment Company Statute. Section 10(l) of that Statute requires the domestic fund asset's to be managed "with the diligence of a conscientious businessman and to protect . . . [the unit holders'] interests." A mutual fund manager allowing, to himself or to others, an excessive sales load would arguably not be protecting the unit holder's interests.


\textsuperscript{93} Id. 61.

note the widely divergent views in the United States with respect to what is an appropriate method of regulation in this area, with the United States views based on a presumption that regulation is appropriate, as against the absence of any regulatory control in West Germany.

C. "Front-end Loading"

The laissez-faire attitude which has been assumed with respect to the size of sales commissions does not carry over into the area of the distribution of sales charges over a period of time with respect to investment plans requiring regular periodic payments. Here, again, the debate in respect to the 1970 amendments of the Investment Company Act of 1940 serves to illustrate the problem.

Section 27(a) of the Investment Company Act of 1940 specifies that the sales load be limited to nine percent of the total payments to be made on a periodic payment plan and requires that no more than one-half of the first twelve monthly payments be applied to this sales load, that the portion of the sales load deducted from the first twelve payments be deducted evenly from those payments, and that the remaining portion of the total sales load be deducted evenly from the remaining payments. The Securities and Exchange Commission, in its "Public Policy Implications of Investment Company Growth," recommended the abolition of the front-end loading practice. In the words of the Senate Report on the 1970 amendment proposals:

> It is of course obvious that such an arrangement is usually detrimental to the investor, particularly if for any reason he discontinues his payments at an early date. Unless the stock market rises rapidly, he is almost certain to lose money.9

On the other hand, the House Report expressed the view that "the

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9See H.R. REP. No. 2337, 89th Cong., 2d Sess. 22 (1966). For the SEC's basis for this recommendation see id. at 223-250.
9S. REP. No. 184, 91ST CONG., 2D SESS. (1970). The report continues:

> Contractual plans are sold to investors in lower economic strata who are not as sophisticated as those who purchase ordinary mutual fund shares. They are usually sold on a door-to-door basis with purchasers being solicited in their homes and offices. While the front-end load feature is fully disclosed, in the prospectus, a survey made several years ago indicates that a few months after the purchase many investors did not realize that they were paying such a load. In addition, if an investor is to avoid paying what is by any standard an excessive sales charge, he must be able to forecast his ability to continue his payments over a period of several years. Studies have shown that few small investors have been able to achieve this result. Consequently, over half of all contractual plan investors fail to complete their payments on schedule and thus usually pay excessive sales charges.
practice of front-end loading is a significant and necessary sales incentive both to the salesmen and to their principals and underwriters."

The Congressional balancing of these two interests was an attempt to put teeth into the disclosure provisions through the requirement that during the first eighteen months after a front-end loaded plan is sold to an investor he is entitled to, and is to be separately and specifically advised of this opportunity if he has missed payments, redeem his interest and receive its net asset value, plus the excess of any sales load that he has paid over 15 percent of his total payments to date. Alternatively, the fund can avoid such refunds by electing to limit its front-end load to an upper limit of 20 percent of any payment and to a maximum average of 16 percent over the first four years. Upon the sale of any periodic payment plan having a front-end load, especially when the sales load deducted exceeds nine percent of any payment, the plan’s custodial bank, within sixty days of the consummation of the sale, must notify the buyer as to the commission amounts to be deducted from each payment. The buyer then has 45 days within which to rescind and receive repayment of all commissions paid plus the net asset value of his investment to that date.

The OECD Standard Rules place no limit on front-end loading while the 1969 Foreign Investment Shares Statute adopts a limitation proportionately stricter than the original American one in that no more than one-third of the individual’s first year’s payments can be applied to selling costs and expenses and the remaining costs must be deducted at a flat rate from the remaining payments. The legislative history states:

A further limitation or a prohibition does not seem sensible, since distribution by agents, who have been largely responsible everywhere for the favorable expansion of investment in mutual funds, is possible only if a larger share of the total costs is charged at the beginning.

The shift of the American mutual fund industry to an emphasis on no-load funds with no sales commissions casts considerable doubt on the

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101 Id. § 27(g)-(h), 15 U.S.C. § 80a-27(g)-(h) (1970).
103 1969 Foreign Investment Shares Statute § 2(4)(c). The effect of this provision forced IOS to cut its front-end load when selling periodic payment plans in Germany from 50% to 33 1/3% of the first year’s payments.

104 BRÜCHER & PULCH, supra note 3, at 65.
need for front-end loading as an incentive to the distribution of the fund. It is to the general advantage of the investor that his mutual fund, through sufficiently wide distribution, be of adequate asset size to achieve the diversification of investment necessary to its purpose of risk spreading. However, the history of the selling of periodic payment programs is so tarnished in both West Germany and the United States it would seem that very little emphasis justifiably could be placed on the encouragement of the type of sales techniques which seem to go along with front-end loading. Most definitely, even the strict limitation of the rate at which the mutual fund salesman can consume his slice of the investor’s pie contained in the 1969 Foreign Investment Shares Statute can have little actual protective effect if the size of that slice remains unlimited.

D. Buyer’s Right of Rescission

The OECD Standard Rules and the 1969 Foreign Investment Shares Statute are more effective in defending the investor against high-pressure persuasion than the Investment Company Act of 1940 in one specific area of what might be described as overenthusiastic sales tactics. Both the 33rd Standard Rule and § 11 of the Statute afford the buyer of the mutual fund shares a right to change his mind and rescind the purchase within a short time period if he purchased the shares as a result of a door-to-door sales campaign. The Standard Rule provision is expressed conditionally, in that it states that “door-to-door sales shall only be permitted” if the rescission right exists for a period of “at least seven days after . . . [the purchaser] has signed an indication of his intention to purchase.”7 The right to rescission under the German statute exists only when the buyer “has been induced to give a statement of purchase through oral negotiations outside of the permanent place of business of the seller,”8 or when the seller “has no permanent place of business,” and when the purchase of the foreign-based mutual fund is not with the scope of the buyer’s business and the sales call is not in pursuance of a preceding request from the buyer.9 This time period, however, is two weeks from the date of delivery of the sales prospectus.10

7OECD Standard Rules 50.
81969 Foreign Investment Shares Statute § 11.
9OECD Standard Rules 50.
101969 Foreign Investment Shares Statute § 11(1).
11Id. § 11(3).
12Id. § 11(1)-(2).
The German Statute, by making specific reference to § 55(1) of the German Trade Law, incorporates the traditional European prejudice against unsolicited door-to-door sales but excepts from these rescission provisions sales in response to a "preceeding request." Little can be said intuitively or empirically, to support any contention that door-to-door sales are not specifically apt to result from unfair or deceptive sales techniques. However, since the Statute only requires that this right to rescission be revealed to the investor in the text of the prospectus and the OECD Standard Rules do not make any provision with respect to the manner in which, if at all, this right is to be revealed, it seems likely that the deceived investor can be specially deceived about this feature of his investment as well. This may be especially true if he has only seven days to two weeks in which to become undeceived. In contrast the special notice provisions and the lengthy period in which rescission is available, and particularly those in respect to heavily front-end loaded plans, as presented in the rescission rights introduced in respect to front-end load periodic payment plans by the 1970 amendments to the Investment Company Act of 1940, appears so effective that Congress

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111West German Trade Law (Gewerbeordnung) §§ 55-64, regulates door-to-door sales generally. In most cases sales licenses are required and certain practices are forbidden. Securities sales may be permitted under regulations adopted by the Federal Minister for Commerce or by the individual state (Länder) governments. Id. §§ 56(1)(1)h, 56(2).

112A realization of the need for remedial practices in connection with door-to-door sales generally is working its way into United States law. In several recent cases, e.g., Time, Inc., CCH TRADE REG. REP. ¶ 19, 564 (FTC Docket No. C-1918), Perfect Film & Chem. Corp., CCH TRADE REG. REP. ¶ 19, 565 (FTC Docket No. C-1919), Neighborhood Periodicals, Inc., CCH TRADE REG. REP. ¶ 20,013 (F.T.C. file No. 712 3118), the Federal Trade Commission has required that sales contracts contain a cooling-off period when the seller has allegedly used unfair and deceptive practices in connection with door-to-door sales.

1131969 Foreign Investment Shares Statute § 3. See note 75, supra.

114Section 27(f) of the Investment Company Act of 1940, 15 U.S.C. § 80a-27(f) (1970), as amended by the 1970 Act required that "With respect to any periodic payment plan, the custodian bank . . . shall mail to each certificate holder, within sixty days after the issuance of the certificate, a statement of charges to be deducted from the projected payments on the certificate and a notice of his right of withdrawal . . . ." Within 45 days after receipt of this notice the certificate holder could surrender his certificate for the net asset value of his account plus the difference "between the gross payments made and the net amount invested" i.e., the entire commission charged. 15 U.S.C.A. § 80a-27(f) (Supp. I. 1973), amending 15 U.S.C. § 80a-27(f) (1970), limits rescission to periodic payment plans "(other than a plan under which the amount of the sales load deducted from any payment thereon does not exceed 9 percentum of any payment)."

115In heavily front-end loaded plans (from 20% to 50% of any first year payment or averaging over 16% of the payments during the first four years) the rescission period extends to 18 months and special notification of this must be made when payments are missed. Investment Company Act of 1940 § 27(d)-(e), 15 U.S.C. § 80a-27(d)-(e) (1970). The commission refund is, however, only the excess commission over 15% of the payments made.
soon provided some relief. If the American investor reads his mail he will be alerted to the loading feature and will have some leisure in which to reconsider his decision.

The OECD Standard Rules and the 1969 Foreign Investment Shares Statute apparently are basically consistent with the Investment Company Act of 1940 once the right of rescission is exercised. All three schemes require the refunding to the investor of the net asset value of his interest either at the time of the rescission or at the time notice of the rescission is received by the fund. Thus, if the fund being sold is open-end, as it must be if it is to be subject to either the Standard Rules or the German Statute, the significant factor in these rescission rights, based on investors’ having second thoughts, is the refund of all or part of the sales commissions charged. The investor is afforded no incentive to wait out the rescission rights period in order to determine how the fund has performed and exercise his right as a “put” if the net asset value drops. Similarly this rescission right would be moot if the fund is both open end and no-load.

VI. Organizational Structure of the Mutual Fund

A. Entity Form

It has been pointed out above in respect to the definitional focus of the OECD Standard Rules and the 1969 Foreign Investment Shares Statute that neither regulatory structure discriminates against or favors any specific entity form with respect to the mutual fund itself or its management. This seems appropriate provided that substantially identical investor protections and rights are present. While the corpo-

114 See note 114 supra.
115 OECD Standard Rules 50 (33rd) Rule, 1969 Foreign Investment Shares Statute § 11(4), Investment Company Act of 1940 § 27(d)-(f), 15 U.S.C. § 80a-27(d)-(f) (1970). The German law states that the value is to be that determined on the day after receipt of the notice of rescission, whereas § 27(d) and (f) of the Investment Company Act of 1940 do not specifically refer to the time of the computation of value. The OECD Standard Rules state that value as of either the time of giving notice or of its receipt is proper.
116 See p. 226 supra.
117 The legislative history of the German provision states that:
This regulatory scheme seems necessary and appropriate, since otherwise market losses would go to the detriment of the assets of the fund and thereby to the detriment of the remaining shareholders, while, in the case of a rise in value, the buyer is always free not to rescind but rather to demand redemption of shares on return for the . . . [net asset value] (although without [recovery of] the costs paid.) BRÜCHER & PULCH, supra note 3, at 83.
118 See p. 242 supra.
rate fund form will provide traditional corporate law mechanisms for the protection of its investor-shareholders, the presence of similar protections when the mutual fund is the product of purely a managerial-custodial arrangement between the fund investors and its managers will depend both upon the terms of the specific arrangement and the extent to which the governing law system applies traditional fiduciary law concepts to the arrangement, thereby treating it as a trust relationship.\(^1\)

It is, of course, appropriate for the regulating jurisdiction to impose minimum requirements on this relationship thereby affording the investor some control over certain changes in the operation or status of the fund. This is the approach utilized by all three of the regulatory schemes examined here. But here the attempt of the OECD Standard Rules to establish standards is clearly minimal. The Standard Rules provide only that assets or titles to assets of the mutual fund "shall be held in a manner acceptable to the supervisory authority"\(^2\) and that either the supervisory authority or the participating investors have the power to approve changes in the "general aims and objectives" of the fund,\(^3\) the assignment of a management contract,\(^4\) or "a change in management."\(^5\) This approach is at its most sophisticated level in the Investment Company Act of 1940 as it deals with investor control and protection.

### B. Control by Shareholders

Fundamentally, the Investment Company Act of 1940 requires in § 18(i) that "every share of stock . . . issued by a registered investment company . . . shall be a voting stock and have equal voting rights with every other outstanding voting stock."\(^6\) Directors of the registered investment company are to be elected by the holders of the outstanding voting securities, except that vacancies of up to one-third of the board can be filled "in any otherwise legal manner."\(^7\) The Act also provides that two important matters must be approved by a vote of a majority

\(^{11}\)As previously noted, supra at note 51, the domestic mutual fund is of the contractual type under West German law. The management company's duty in respect to it is set out principally in § 10 of the 1957 Investment Shares Statute. See p. 242 infra.

\(^{12}\)OECD Standard Rules 36 (18th Rule).

\(^{13}\)OECD Standard Rules 22 (1st Rule).

\(^{14}\)OECD Standard Rules 37 (20th Rule).

\(^{15}\)OECD Standard Rules 38 (21st Rule).


of the outstanding voting securities: the investment advisory (management) contract and change in its investment policies.

The 1970 amendments to the Investment Company Act of 1940 substantially clarified the shareholders' control over investment policy changes by requiring that in its registration statement, and in addition to the itemization of policies required by § 8(b)(1), the investment company recite both "all [other] investment policies . . . which are changeable only if authorized by shareholder vote" and "all [other] policies of the registrant . . . in respect of matters which the registrant deems to be matters of fundamental policy." Section 13(a)(3) now makes it clear that the investment company cannot deviate without shareholder approval in respect to either category. Prior to this amendment §§ 8(b)(2) and 13(a)(3) covered only fundamental policy and there existed some doubt as to whether the language covered unitemized matters of investment policy not voluntarily labeled "fundamental" by the fund.

It is significant to note that, in applying the specific contractual term requirements § 2(4) of the 1969 Foreign Investment Shares Statute, the German Federal Supervisory Office for Credit Affairs has apparently followed the Securities and Exchange Commission's usage of "fundamental policy" by requiring that United States funds qualifying for sale in West Germany comply with the provision that certain of the "contractual conditions" contained in that section "be adopted as 'fundamental policy' of the fund or otherwise be treated so that it cannot be changed without shareholder vote." Specifically these matters of fundamental policy are: that the shareholder can require redemption of his interest in the fund; that the fund will not acquire securities issued in another investment company; that securities or other assets in the

136 Memorandum of Robert L. Augenblick, President, Investment Company Institute, to members of the ICI, No. 70-71, September 27, 1971, at 3 [hereinafter cited as ICI MEMO]. Since these restrictions are required conditions to distribution in Germany, a shareholder vote changing them would presumably result in a stop order from the Supervisory Office.
137 1969 Foreign Investment Shares Statute § 2(4)(b); ICI MEMO., supra note 136, at 5.
138 1969 Foreign Investment Shares Statute § 2(4)(d); ICI MEMO., supra note 136, at 6.
fund's portfolio shall not be pledged;\textsuperscript{139} that only in special cases can the fund borrow and then only short term in an amount equal to no more than 10 percent of its assets (in which case assets equal to the loan amount may be pledged);\textsuperscript{140} and that the fund not engage in selling short.\textsuperscript{141}

Other than these provisions, the German Statute does not force shareholder approval upon any changes in fund organization, policies, or management. The foreign-based mutual fund must obligate itself to the notification of the Federal Supervisory Office as to "material changes of circumstances" reported in its notification to the Office of its intention to distribute shares in West Germany,\textsuperscript{142} but there is no requirement that such changes be reported to the shareholder-investor.\textsuperscript{143} While the by-laws or management regulations of a domestic West German mutual fund are not subject to shareholder-investor approval, they must be specifically approved by the Federal Supervisory Office\textsuperscript{144} according to specific standards.\textsuperscript{145} The Supervisory Office exercises no such control over foreign-based funds and, if not restricted by the law of the jurisdiction in which the fund has been organized, marked changes in investment policy and other matters are conceivable and beyond control.

While the OECD Standard Rules do not require that any matters in respect to a fund be submitted for shareholder-investor approval, this alternative to approval by the supervisory authority, or a trustee in one instance, is offered in the three situations of change in investment policy, assignment of the management contract, and change in management.\textsuperscript{146}

C. Existence and Rights of Different Classes of Securities or Debt.

Since neither the OECD Standard Rules nor the 1969 Foreign Investment Shares Statute specifically requires any shareholder control, in turn neither contains any voting rights requirement similar to § 18(i)\textsuperscript{147} of the Investment Company Act of 1940. Neither contemplates nor prohibits different classes of equity securities with different claims or

\textsuperscript{139}1969 Foreign Investment Shares Statute § 2(4)(e); ICI MEMO., supra note 136, at 7.
\textsuperscript{140}1969 Foreign Investment Shares Statute § 2(4)(g); ICI MEMO., supra note 136, at 8.
\textsuperscript{141}1969 Foreign Investment Shares Statute § 7(2)(6)(b).
\textsuperscript{142}See id. § 4 for a description of the information which the fund must publish in West Germany and when and where it must be published.
\textsuperscript{143}1957 Investment Company Statute § 15 (2).
\textsuperscript{144}Id. § 15(3).
\textsuperscript{145}See p. 237 supra.
rights. In contrast § 18(f) of the '40 Act prohibits a United States registered open-end investment company from issuing any class of senior securities except in "series companies" in which a series or class may be preferred in respect to certain assets allocated to it. Thus, fund sponsors under either regulatory scheme are theoretically free to create and own a preferred class of securities entitled to, for example, a disproportionately large allocation of any fund gains together with a disproportionately small share of any losses.

Both the OECD Standard Rules and the 1969 Foreign Investment Shares Statute place strict limitations on debt issuance by a mutual fund. The German Statute requires that the fund prohibit itself from borrowing more than an amount equal to 10 percent of the fund's asset value and from borrowing anything at all except in "special cases." The legislative history states that borrowing is thus to be permitted only when "the borrowing is not made for the purpose of speculation" and "particularly in consideration of the cases in which the investment company is faced with massive demands for redemption which it can meet without damage to the fund only if it provides itself with the requisite cash only by borrowing rather than by selling securities under unfavorable conditions."

The Standard Rules limit the amount to be borrowed to 20 percent of the fund's total assets. If the borrowing is for redemption purposes it is considered "as being in the nature of an exceptional or emergency measure" and "the money so borrowed shall be repaid within a brief period of time satisfactory to the regulatory authority." If the borrowing is for the purpose of leverage it is to be reduced immediately if the decline in the market value of the fund assets brings it above the 20 percent ceiling, thereby substantially limiting the use of long-term debt. The majority of the OECD experts were opposed to permitting any borrowing whatsoever.

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148 This would be the equivalent of an "upside only" incentive or performance management fee now forbidden in respect to the management of United States investment companies by § 205 of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-5 (1970).
149 1969 Foreign Investment Shares Statute § 2(4) (e), (f).
150 Brücher & Pulch, supra note 3, at 67.
151 OECD Standard Rules 32 (14th Rule).
152 Id. at 32.
153 Id. at 33.
154 Id. at 32.
VII. INVESTMENT OPERATIONS OF THE MUTUAL FUND

A. Valuation of Shares

It has been observed above that under the 1969 Foreign Investment Shares Statute the fund is required to publish continuously on a daily basis the sales and redemption price of fund units. The OECD Standard Rules require that the sales prospectus state the frequency with which the net asset value, the sales price, and the redemption price are to be calculated, and that these values be calculated "reasonably frequently, but at least once a month." While the German Statute contains no criteria with respect to the manner in which the asset value and the unit net asset value are to be determined, the OECD Standard Rules require that the method and procedure for valuation be both satisfactory to the supervisory authority and set out clearly in the prospectus. The comments on this Rule suggest that it is a "sound and recommendable practice to value at the price of the latest transaction which took place on a securities exchange or at the latest bid price, securities . . . for which market quotations are readily available and to value any other securities at a fair price determined in good faith by the board of directors" of the fund. The fact that annual reports submitted to the Supervisory Office by funds being sold in Germany must be certified by a certified public accountant, or his equivalent, seems to indicate that at least this annual valuation will be determined according to something akin to generally accepted accounting principles and will meet the requirement of the Standard Rules that "compliance of valuation with such [announced] methods and procedures [of asset valuation] shall be verified periodically by an independent auditor." Valuation of untraded or restricted securities and of real estate has been a substantial problem, both in the United States and with respect to offshore funds. The incentive for overvaluation is found principally in the enhancement of the fund’s performance record, most particularly

155 See p. 229 supra.
156 See p. 228 supra.
157 OECD Standard Rules 42 (25th Rule).
159 Id. at 37.
160 1969 Foreign Investment Shares Statute § 7(6) (a).
161 OECD Standard Rules 37 (19th rule).
163 See, e.g., RAW, PAGE & HODGSON, supra note 2, at 294-301.
if part of the management fee is based on fund performance. Its most serious effect, however, is a long-term effect upon investors who remain in the fund after an excessive upward valuation or new investors who participate in reliance on it. Very substantial opportunities for manipulation are presented by this situation.

The suggestion from the comments on the OECD Standard Rule is taken directly from § 2(a)(41) of the Investment Company Act which requires that where market quotations on a portfolio investment are not readily available, the fair value of these securities or assets are to be determined “in good faith by the board of directors.” This seems perhaps the most significant and important fiduciary-type duty which can be placed upon the persons in control of the management of a mutual fund.

B. Independence of Management

Neither the OECD Standard Rules nor the 1969 Foreign Investment Shares Statute require the creation of any general or specific fiduciary duty owed by the fund management to the investors. Except in certain instances when the supervisory authority or a custodian bank may become involved, control of this nature is left to other provisions of the law of the jurisdiction in which the fund is organized and may be totally lacking if the relationship between the investor and the fund managers is purely contractual.

The omission from the West German Statute of any requirement of independent management supervision is particularly striking in view of the substantial supervision which the Federal Supervisory Office for Credit Affairs itself undertakes in respect to the management of domestic mutual funds. Not only is a fiduciary duty to the investors specifically imposed and a supervisory board of directors [Aufsichtsrat] specifically required, but the Supervisory Office must pass upon both the reputation and expertise of the members of the board.

The usage of the Aufsichtsrat in German corporate law bears some similarity to the United States requirement that at least 40 percent of the members of the board of directors of a registered investment com-

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165 See pp. 236-37 supra.
166 See pp. 223-24, 226-27 supra.
167 1957 Investment Company Statute § 10 (1).
168 Id. § 3.
169 Id. § 4(1).
pany, except a no-load open-end fund, be persons who are not "interested persons" as defined under the Act. Members of this supervisory board are required to have some independence in that they cannot be otherwise employed by the corporation which they supervise, or be members of its management board (Vorstand).

The OECD Standard Rules regulate conflict of interest situations and self-dealing in a manner strikingly similar to §17 of the Investment Act of 1940. The Standard Rules prohibit transactions "directly or indirectly" between certain persons and the fund itself, the management company or the distribution company which involve the buying or selling of securities for their own account, or the granting or receiving of loans for their own account unless "the supervisory authority agrees that the interests of the participating investors are not prejudiced thereby." Persons subject to this prohibition are directors, officers and employees of the fund and the families of these individuals, the fund's trustee, its management company and distribution company, 10 percent voting shareholders in the fund or any of these companies, and "all persons who through affiliation are liable to come directly or indirectly under the influence of the above," a provision which would presumably include comanaged funds. While the differences are not of crucial significance, the class of persons subject to the Standard Rules is more closely that of the more extensive class of "interested persons" as that term is used in the amended '40 Act than that of "affiliated person," though it is the latter that is subject to the §17 conflict restrictions of the '40 Act. The transactional coverage is coextensive with §17(a); the broader coverage of §17(d) and (e) is not present.

C. Character of Investments and Investment Policy

The regulation of the disclosure of investment policy by the OECD Standard Rules and the 1969 Foreign Shares Statute and encum-

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175Id. 40.
180See p. 230 supra.
branches on changes in that policy have been discussed above. Both regulatory schemes, however, place distinct restrictions on investment policy by prohibiting or limiting certain investment strategies and concentrations. For example, both prohibit short selling. The Standard Rules severely restrict leveraging, whereas the German Statute appears to prohibit it in respect to securities. Neither scheme requires that the fund limit itself to listed or publicly-traded securities. Both permit trading in put and call options, i.e., hedging, but the Standard Rules specifically prohibit a fund from incurring the liability inherent in writing call options on securities it does not own, a risk similar to that present in short selling. As previously noted, the OECD Standard Rules do not cover real estate funds, whereas the 1969 Foreign Investment Shares Statute does.

A matter of special interest is that both regulatory schemes restrict investment by the fund in other mutual funds, the OECD Standard Rules by prohibiting a fund from selling its shares "if it is aware that the buyer is another . . . [fund] and that the sale would cause the buying . . . [fund], either individually or with other . . . [funds] belonging to the same group, to become the holder of more than 5 to 15% of the shares of the selling . . . [fund]" and the 1969 Foreign Shares Statute by adopting the 1957 Investment Company Statute's prohibition on the acquisition of shares in another fund. Parallels to both controls may be found in § 12(d)(1) of the Investment Company Act of 1940. The parallel to the German Statute is found in the original § 12(d)(1) of the '40 Act, which prohibited a registered investment company from acquiring "more than 3 percent of the outstanding voting stock of another investment company unless it already owned 25 percent or more of such stock."

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183See pp. 238-39 supra.
182OECD Standard Rules 31 (13th Rule); 1969 Investment Shares Statute § 2(4) (g).
181OECD Standard Rules 32 (14th Rule); see p. 240 supra.
1841969 Foreign Investment Shares Statute § 2(4)(e), (f); see pp. 239-40 supra. But note that real estate may be leveraged under certain circumstances. Id. § 2(4) (f).
185OECD Standard Rules 33 (15th Rule).
186And a transaction which might fit under the specific language of § 2(4)(g) of the 1969 Foreign Investment Shares Statute prohibiting short sales of any assets.
188OECD Standard Rules 30 (11th Rule). The buying fund also is prohibited, by the 9th Rule, from acquiring more than 5 to 15 percent of the voting securities of any one issuer, including another fund. Id. 28.
1891969 Foreign Investment Shares Statute § 2(4)(d) referring to 1957 Investment Company Statute § 7(6) [now § 8(6)].
180See H.R. REP. No. 1382, 91st Cong., 2d Sess. 23 (1970); This section is basically 15 U.S.C. § 80a-12(d) (1) (A) (1970).
§ 12(d)(1)(B) of the '40 Act as amended in 1970, which makes it "unlawful for a registered open end company, its principal underwriter or any broker-dealer registered under the Securities Act of 1934 to sell or otherwise dispose of a security issued by a registered investment company if, as a result of the transaction and to the knowledge of the seller, the [ownership] limitations in that subparagraph would be exceeded." These provisions of § 12(d)(1)(B) and the companion provisions of § 12(d)(1)(C) and (F) were added to the '40 Act specifically to deal with problems inherent in the creation of "several unregistered foreign-based fundholding companies investing primarily in the securities of American mutual funds," specifically the IOS-created Fund of Funds, Ltd. Since the restrictions of § 12(d)(1) had previously dealt only with purchases by registered investment companies and the Fund of Funds was not and could not be registered, the additional control was thought necessary.

D. Size and Computation of Management Fees

The charging of allegedly excessive management fees, particularly in the case of large mutual funds when the fee is a percentage of the assets under management and does not take into account management economics of scale, has been the source of much recent litigation in the United States. Prior to the 1970 amendments, however, the duty of the mutual fund manager to the fund and the standards by which fees were measured were unclear and inadequate. Section 36 of the Investment Company Act of 1940 required a showing of "gross misconduct or gross abuse of trust," i.e., that the fee "shocked the conscience of the court." After some differences of opinion about whether, for example, excessive management fees could be controlled if the approval of the management contract by a majority of the unaffiliated directors and the shareholders were required, Congress promulgated standards which contemplate "a breach of fiduciary duty involving personal misconduct" and explicitly provide that "the investment adviser of a

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See Raw, Page & Hodgson, supra note 1, at 85-88.
registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services," but that while it is unnecessary to show "personal misconduct" in respect to breach of this fiduciary duty, "the plaintiff shall have the burden of proving a breach." 200

As has been stated above, 201 no such fiduciary standard is available to the investor under either the OECD Standard Rules or the German 1969 Foreign Investment Shares Statute, nor does either scheme impose any requirement of periodic review and approval of the terms of the management or investment advice contracts as is done by § 15(a) of the Investment Company Act of 1940. 202 Besides requiring the disclosure of the terms of the management contract in the sales prospectus, 203 the OECD Standard Rules require generally only that the management agreement be in writing, that it "contain details concerning the services to be rendered and the payments to be received . . . .", and that its assignment be subject to prior approval. 204 The 1969 Foreign Investment Shares Statute requires only that the prospectus contain a description of the compensation and expenses to be paid to other parties out of the fund. 205

The OECD Standard Rules afford a certain amount of attention to the problems inherent in performance or incentive management fees by the requirement that such fees "be permitted only subject to close scrutiny by the supervisory authority as to their reasonableness, their method of calculation and the identity of those against whom they are charged." 206 There is no suggestion, as is found in United States law, that an investment advisory fee which increases with capital gains or capital appreciation but which does not decrease with losses or depreciation is unreasonable, 207 "a 'heads I win, tails you lose' situation." The OECD Standard Rule comments only point out that while incentive or

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200 Id. § 3(5)(b)(1), 15 U.S.C. § 80a-35(b)(1) (1970). Approval by the Board of Directors shall be given "such consideration by the court as is deemed appropriate under all the circumstances."
201 See pp. 236-37, 241-42 supra.
203 See note 67 supra and accompanying text.
204 OECD Standard Rules 37 (20th Rule); see p. 237 supra.
205 1969 Foreign Investment Shares Statute § 3(2)(5).
206 OECD Standard Rules 39 (22nd Rule).
performance fees might be "well earned" they also "might tempt the management . . . (which could not share in any resulting losses) to accept unwarranted risks" and "should therefore never be excessive lest they involve the management in a conflict of interest."208

VIII. REDEMPTION OR SALE (BY THE INVESTOR) OF MUTUAL FUND SHARES

A. Right of Redemption

The OECD Standard Rules definitionally210 and the 1969 Foreign Investment Shares Statute as a matter of "fundamental policy"211 exclude closed-end funds, except that a closed-end fund which provides directly or indirectly, for redemption of its shares would be clearly permissible under the Standard Rules212 and perhaps allowable under the German Statute.

The OECD Standard Rules comments describe the right of redemption as an "essential feature"213 of a mutual fund and the legislative history of the German Statute notes that the open-end form "has proved to be advantageous in comparison with the so-called closed-end form because only in the case of the open-end form is it assured that the price of the shares depends exclusively on the value of the assets of the fund and is not additionally influenced by supply and demand relative to the shares."214

Redemption rights have in fact been a key focus of these two regulatory schemes. Redemption rights, by providing complete liquidity, offer the ultimate safety exit for the investor, and perhaps the only exit if rescission rights are either nonexistent or severely limited.215 In many instances the investor's only available influence upon or response to, investment and managerial policies to which he objects will be to liqui-date his investment.

For these reasons both the OECD Standard Rules and the 1969 Foreign Investment Shares Statute are detailed and explicit with respect

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2111969 Foreign Investment Shares Statute § 2(4) (b); see note 137, supra and accompanying text.
212OECD Standard Rules 22.
213Id. at 43.
214B RÜCHER & PULCH, supra note 3, at 65. Similarly domestic mutual funds in Germany must be in the open end forum. Id. However, these requirements of the 1969 Foreign Investment Shares Law do not apply if the fund is listed on a German stock exchange and is not otherwise publicly offered. 1969 Foreign Investment Shares Statute § 1(2).
215See pp. 225, 234 supra.
to redemption requirements. The OECD Standard Rules require that redemption be "at the option of the participating investor," that the redemption price for all participating investors "equal the net asset value per share . . ., less any redemption charge, calculated . . . the last time before or the next time after the request for redemption is received . . .," that "payment shall be made as soon as possible but in any case not later than 5 to 30 days after receipt of the request for redemption," and that "payment shall be made in cash in the currency in which the . . . [fund's] assets are valued, unless redemption by means of portfolio securities is expressly authorized by the supervisory authority as being not detrimental to either the redeeming or the remaining participating investors."\(^{216}\)

Section 2(3) of the 1969 Foreign Investment Shares Statute requires that the foreign-based mutual fund appoint "one or more domestic banks (Kreditinstitute) . . . as paying agents through which payments made by, or designated for, the holders of the shares may be made" and that "it must be assured" that amounts paid through these agents "are passed on to the [fund's] bank of deposit [Depotbank] without undue delay."\(^{217}\) The Federal Supervisory Office for Credit Affairs has reputedly been very strict in applying the requirement of "without undue delay" requiring that transfers of investments into United States funds be accomplished by telegraphic or other means on the same day that the funds are received by the paying agent in West Germany. The suggested contractual conditions which must be adopted as a matter of "fundamental policy" if a United States fund is to be marketed in West Germany, however, under normal conditions allow the fund seven days from receipt of the redemption request in which to pay to the investor in cash the net asset value of his interest.\(^{218}\)

B. Suspension of Rights of Redemption

The allowance by the German Supervisory Office of seven days in which United States funds are to pay out funds on redemption is consistent with the requirement of § 22(e) of the Investment Company Act of 1940,\(^{219}\) which in addition allows the fund to suspend redemption

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\(^{216}\)OECD Standard Rules 43 (26th Rule).

\(^{217}\)1969 Foreign Investment Shares Statute § 2(3). The Regulation of August 26, 1969, para. 14.1 requires confirmation by the paying agent that it assumes this function and will transfer funds directly and without undue delay; and para. 13.2, that the route of payments from the paying agents to the bank of deposit and vice versa be described in the fund's notification statement.

\(^{218}\)ICI MEMO., supra note 136, at 4, 5.

when the New York Stock Exchange is closed or trading thereon is restricted or during certain other emergency conditions in which the Securities and Exchange Commission deems suspension of redemption necessary for the protection of the investors. The necessary contractual condition requires Securities and Exchange Commission determination of the existence of any of these conditions as does the '40 Act with the exception of closing of the New York Stock Exchange.\textsuperscript{220} The United States law, however, explicitly requires that the seven day period run from receipt of the request for redemption by the fund's agent, a requirement implicit in the German law.

Further, though the German position is to require a cash redemption at all times, it is recognized that if a fund has filed an irrevocably binding election under Rule 18f-1 of the Investment Company Act of 1940\textsuperscript{221} it may redeem the interest of any one investor with noncash property when his requests for redemption over a 90-day period involve an amount in excess of the lesser of $250,000 or one percent of the total net asset value of the fund at the beginning of the period.\textsuperscript{222} There are in the German Statute no other conditions in which the fund could fail to redeem its shares in cash.

The OECD Standard Rules require that redemption “shall not be suspended unless exceptional circumstances prevail under which it is, in particular, not reasonably practicable to ascertain the value of the assets of the . . . [fund] or to dispose of them and unless the approval of such suspension by the supervisory authority of the country where the . . . [fund] is established has been obtained.”\textsuperscript{223} The comments to this rule describe the exceptional circumstances “due to force majeure and such-like” under which suspension of redemption rights might be appropriate,\textsuperscript{224} but point out that “the idea that the redemption right should be suspended only if a certain minimum percentage of the . . . [fund's] assets is involved in the emergency or, in other words, if at least X percent of the portfolio securities cannot be valued or sold [had been] rejected as too rigid.”\textsuperscript{225} The suspension of redemption in cash is obviously necessary when the assets of the mutual fund cannot be sold, i.e., when the usual securities markets are not functioning in an orderly manner, and redemptions in

\textsuperscript{220}Id.
\textsuperscript{221}Reg. 270.18f-1, adopted June 14, 1971.
\textsuperscript{222}ICI MEMO., supra note 136, at 4.
\textsuperscript{223}OECD Standard Rules 44 (27th Rule).
\textsuperscript{224}Id. at 45.
\textsuperscript{225}Id.
kind may be inappropriate as well under these circumstances since the fund most likely will be in a better position to liquidate its assets than the investor will be due to his fractional interest in them. However, when the problem is one of the valuation rather than the liquidity of assets, suspension of redemptions may be a tardy and stopgap remedy if the valuation problem arises out of substantial investment by the fund in inactively traded securities. Such a situation would appear to necessitate preventive measures.

The OECD Standard Rules attempt in two ways to prevent problems in respect to individual funds which might develop into circumstances in which redemption might have to be suspended. The first is the requirement in the 16th Rule that "a high percentage of the assets of a . . . [fund] (75% to 90%) shall be in a readily realizable form." The second is the provision in the 8th Rule that requires substantial diversity in providing that a fund "shall not invest more than 5 to 15% of its assets in the securities of any one investor."

In the further prevention of the conditions which might necessitate the suspension of redemption, it is also quite possible that the regulating authorities could take the view that substantial investments in assets that are difficult to value and/or difficult to dispose of is absolutely inconsistent with, and therefore violative of, the requirement of both the OECD Standard Rules and the 1969 Foreign Investment Shares Statute that the fund be continuously obligated to redeem its shares. The Securities and Exchange Commission has hinted at this approach in respect to investments by United States open end funds in restricted securities.

The necessity of such rigid control over investment practices which might result in the absence of liquidity is readily apparent when factors frustrating adequate regulation once redemption is suspended are viewed. Under the 1969 Foreign Investment Shares Statute the only remedy upon the suspension of redemption is the termination of new sales of the fund in West Germany. This remedy is obviously unsatisfactory to the currently participating investor since new sales are often the sole actual source of new cash with which to redeem his shares. On the other hand, suits by the investors against the fund, through its German

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\textsuperscript{22} Id. at 34 (16th Rule).
\textsuperscript{27} Id. at 27 (8th Rule). Compare id. (8th Rule) with Investment Company Act of 1940 § 5(b) (2), 15 U.S.C. § 80a-5(b) (2) (1970) in respect to a "diversified [management investment company]."
representative, cannot be expected to yield satisfactorily when the grounds for the suits are, in fact, the fund's real inability to provide for even a small number of redeeming shareholder's claims. Thus, close supervision of both the potential effect of investment practices upon redemption and of the conditions under which redemption may be suspended seem too important to be left solely to regulation by the country in which the fund is organized and domiciled, as is the practice with both Standard Rules and the Statute.

C. Depository Protections

It is more a European than American concept that substantial protection to investors in a mutual fund can be provided by close supervision of the custodian of the fund's assets and that control of the custodian is as important, if not more important, than control of the fund's management. Section 17(f) of the Investment Company Act of 1940 grants a registered management company the choice of placing and maintaining its securities and other investments in the custody of (1) a bank with an aggregate capital, surplus and undivided profits of not less than $500,000, or (2) a national securities exchange member firm, or (3) the company itself. If the company retains the securities itself it is required to deposit them for the purpose of safekeeping. The 1970 amendments permit the fund to use more than one bank as custodians if it so chooses but require that if "securities and similar investments" are in the hands of a bank custodian, the fund's cash is to be in the hands of the bank as well, on the grounds that "shareholders would appear entitled to expect that the cash held by the company would be afforded a degree of protection similar to that given to securities."

In contrast, the 1969 Foreign Investment Shares Statute's primary requirement in respect to the structure of mutual funds selling shares in Germany is that their assets be in the custody of a bank of deposit (Depotbank) with characteristics of supervision over the account comparable to those required of the custodian bank of a domestic fund by § 11 (now § 12) of the 1957 Investment Company Statute. The mutual fund and the custodian bank must not have common agents and

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See 1969 Investment Shares Statute § 2(1) and § 6. The Federal Supervisory Office for Credit Affairs apparently regards as a major deficiency in the Statute that a domestic representative of only the foreign-based mutual fund itself is required and not of the management company, the underwriter or the custodian bank. See Investment Company Institute MEMO., No. 14-1971, March 8, 1971, at 9-10.


1969 Foreign Investment Shares Statute § 2(2).
employees; the Federal Supervisory Office for Credit Affairs must specifically approve the bank; the bank must have equity capital of at least 10,000,000 DM; it must hold the fund’s securities in a blocked account, must handle all purchases, sales and redemptions on instruction from the fund, must see that the purchase and sale of portfolio assets are at proper prices, and must control the payment of management fees and expenses. More significantly, the custodian bank must be "entitled and obligated, in its own name" (1) to assert claims of the fund’s investors against the fund, its management and any former custodian bank and (2) to defend the fund against improper judgments and executions.

It is readily apparent that the placement of these responsibilities on the custodian bank, going substantially beyond the custodial duties usual in American law, can be an effective substitute for many of the controls which have been omitted from the German Statute. Here the tradition of regulation by expert exercise of fiduciary duty has been honored rather than the American tradition of investor control. A skilled bank custodian, to the extent that it is made specifically responsible under the regulatory scheme, is obviously better equipped to protect the investor against mismanagement than is the nonskilled investor himself, or even perhaps diligent, but possibly nonskilled, independent directors.

At first there existed some substantial doubt as to whether a United States custodian bank could offer the shareholder in a registered United States investment company security comparable to that available under the German domestic law requirements and thus enable a United States registered fund to comply with this prerequisite to distribution in West Germany. This problem has been solved substantially, however, by the Federal Supervisory Office for Credit Affairs view that “the totality of . . . [the United States] regulatory pattern (system of ‘checks and balances’ as they put it) would generally be accepted . . . as satisfying the requirement that there be comparable security to the role which German custodian banks play in the case of German funds.” The Supervisory Office thus recognizes that unlike German funds, U.S. funds have shareholders with voting rights

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2331957 Investment Company Statute § 12.
234Id. § 12(8).
(including the right to sue management) and a board of directors (including independent directors), are subject to close regulation by the SEC under the Investment Company Act, are subject to regulation by State Securities Administrators, that the sales of shares of most mutual funds are also regulated by the NASD, that independent certified public accountants as part of their audits make spot-checks on certain fund activities, that funds make detailed periodic reports to the SEC and shareholders and are subject to an SEC inspection program, and that fund organizations carry fidelity bonds.237

The Supervisory Office has indicated, however, that exculpatory clauses in agreements limiting the liability of custodian banks to gross negligence or willful misconduct are improper and that banks should be held liable for ordinary negligence.238

The OECD Standard Rules assume a neutral position in respect to the custody of assets, requiring only that the assets "be held in a manner acceptable to the supervisory authority."239 This position is apparently the result of divergency of custodial practices in different countries.

The West German recognition that a key factor in the regulation of mutual funds, i.e., the security for investors found in the powers and duties of custodian banks under domestic law, can be supplied by the alternative means of the total regulatory structure with respect to United States registered investment companies, represents imaginative regulation, particularly when the literal language of the § 2(2) of the German Statute240 does not quite suggest this. In the particular case this interpretation seems both appropriate and justified. Such an interpretation is in fact possible on a much broader base in the United States under § 7(d) of the Investment Company Act of 1940 which authorizes the Securities and Exchange Commission,

upon application by an investment company organized or otherwise created under the laws of a foreign country, to issue a conditional or unconditional order permitting such company to register . . . and to make a public offering of its securities . . . if the Commission finds that, by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions . . . [of the Investment Company Act] against such company that the issuance of such order is otherwise consistent with the public interest and the protection of investors.241

238Id. at 10.
239OECD Standard Rules 36 (18th Rule).
2401969 Investment Shares Statute § 2(2).
In viewing critically the OECD Standard Rules and the 1969 Foreign Investment Shares Statute it is necessary to keep in mind constantly the limited purposes of each. This is particularly true in the case of the OECD Standard Rules which are specifically designed only to provide necessary minima and do not propose to present a comprehensive system for the regulation of mutual funds. Likewise, the 1969 Foreign Investment Shares Statute deliberately does not attempt to regulate all aspects of foreign-based mutual funds which are sold in Germany but only to provide minimal safeguards which make these sales at least tolerable.

In addition, it is readily apparent that the OECD Standard Rules are the product of some disagreement and compromise among the participating member nations and their experts. Of the 32 substantive rules promulgated, five leave key matters open to a determination of what is acceptable to the supervisory authority. This inability to agree seems to be not the product of political differences but rather the result of ideological clashes in attitudes toward the regulatory role itself, and the natural, but perhaps political, desire on the part of each country's representatives that his own country's current regulatory scheme and practices be able to meet the OECD minimal standards with minimal strain. To the extent that this latter influence is at work, there exists a tendency of the OECD Standard Rules to become the "lowest common denominator" of mutual fund regulation. This is a trend to be avoided, for in this area in particular, in which the national attitudes are widely divergent because of differences in ideology, practical experience, and sophistication, uniformity and harmonization are less important goals than effective regulation that provides sufficient protection and opportunity to the domestic investor. It is to be hoped that in their continuing efforts concerning mutual fund regulation the OECD's Committee on Financial Markets and its experts will concentrate on refinement and extension of the coverage of the standards by drawing on the empirical realities and will resist, so far as possible, any pressure for standards which

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242Of the 23 member nations, only 13, Austria, Canada, France, the Federal Republic of Germany, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, Switzerland, the United Kingdom and the United States participated by providing expert representation. Australia, Belgium, Denmark, Finland, Greece, Iceland, Ireland, Japan, Norway and Turkey did not. OECD Standard Rules 73-75.

242OECD Standard Rules 36 (18th Rule: Custody); Id. at 37 (19th Rule: Valuation of Assets); Id. at 39 (22nd Rule: Incentive Fees); Id. at 49 (31st Rule: Advertising and Additional Sales Literature); and Id. at 50 (32nd Rule: Salesmen).
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can have wide acceptability only because they achieve uniformity through lack of real impact. Uniformity, which is undoubtedly desirable as mutual funds become more prevalent as transnational vehicles of investment, will in fact be achieved on a "highest common denominator" basis as multinational funds are required to meet the standards of the country with the highest qualifications. The best that can be expected from international co-operation here is that it will harmonize standards that are in direct conflict and eliminate those that are ineffective or unnecessary.

The limited purpose of the 1969 Foreign Investment Shares Statute presents a more perplexing problem in that it creates a two-tiered regulatory arrangement in which mutual fund shares being sold in West Germany are the subject of one of two very substantially different regulatory schemes depending solely upon whether the fund is organized under domestic laws or under the laws of some foreign country. This seems a very unsatisfactory distinction on which to base the regulatory difference. Worse still, as this article has indicated, in various respects the statutory scheme regulating foreign-based funds is substantially more liberal than the scheme regulating domestic funds. As it stands, the less scrupulous fund promoter organizing a new fund to be sold in West Germany will likely choose to go "offshore" in order to avoid the more rigorous domestic scrutiny. A countervailing factor exists to the extent that the buying public is aware of the meaning of the absence of the *imprimatur* of quality of the Federal Supervisory Office for Credit Affairs with respect to foreign-based funds, but unfortunately no more is really known about this than is known about the alleged attractiveness to foreign investors of the fact that a United States registered fund must meet the relatively rigorous requirements of the Investment Company Act of 1940. Nevertheless, and despite the practical and administrative difficulties in applying domestic German standards to offshore funds, a substantial weakness can be seen in any regulatory scheme which offers an incentive to escape from domestic controls.

It has been the purpose of this article to point out a number of the basic differences in the regulatory impact of the three schemes examined here. These regulatory differences may appear all the more striking as the real economic structures of mutual funds achieve greater uniformity through their increased transnational activities. To the extent that such differences can be explained by variations in national regulatory habits and attitudes, any discussion of them may have value only as scholarly entertainment. On the other hand, if they are the product of real differences of opinion as to the efficacy of alternative methods in controlling
the marketing of investment opportunities examination of them increases in importance. The greater portion of the resolution of these questions of efficacy unfortunately has been attempted on an intuitive rather than an empirical basis. Real evaluation of different practices in the regulation of mutual funds and their results will have to await more objective probing and measurement.