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CANADIAN INVESTMENT COMPANIES AND AMERICAN INVESTORS

Address by

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A recent article in the Wall Street Journal based on reports by the Department of Commerce points out that American investments in Canada have increased from about $3.6 billion at the end of 1950 to nearly $5 billion in mid-1953. The rate of American investment in Canada has increased sharply during this period over the rate from 1946 through 1950. In the earlier period it was at about $200 million per annum; in the latter period at about $500 million per annum. Since 1950 the investments have been made in large part in petroleum and mining; before that the largest part was in manufacturing. Approximately 90% of the total United States investment has been in companies owned about 75% by a controlling U. S. investor or a controlling group of U. S. investors, with the remaining 25% owned by Canadians and others and often represented by a public holding. A large proportion of the corporation used as a medium for this investment are Canadian corporations.

These figures certainly indicate that more and more Americans want to invest in Canadian enterprises. Indeed, such investment is encouraged by our government, as was indicated in the President's Message on the State of the Union delivered February 2, 1953. Therefore it is important that the Securities and Exchange Commission consider carefully what it can do to facilitate such investment under the various Acts which it administers.

One way an American can put his money into a Canadian enterprise is by buying shares in an investment company whose investments include or are limited to Canadian industrial, petroleum or gas stocks. Such an

investment company can be either an American corporation or a Canadian corporation, organized either under the Canadian Companies Act or under one of the provincial corporation laws.

The type of corporation used has important tax implications. If it is a Canadian corporation, it is entitled to make an election under the Canadian tax law by reason of which the dividends it receives from its Canadian investments are not taxable by Canada. Furthermore, Canada does not tax capital gains, and Canadian counsel seem to be of the opinion that the gains which would be derived by a Canadian investment company from the purchase and sale of its portfolio securities would be considered capital gains, rather than ordinary income as Americans conceive of that term, and would not be subject to taxation in Canada. If a Canadian investment company can operate in a manner so as to preserve its status as a non-resident foreign corporation under our own tax laws, that is, it is not engaged in trade or business in the United States, then except to the extent its income is from sources within the United States, its income is not subject to taxation by the United States whether or not it is currently distributed. Nor are the company's capital gains taxed by the United States irrespective of their source.

It follows that this kind of a company is taxed very little, if at all, and yet is not required to distribute to its stockholders any of its earnings or capital gains. If it does distribute the earnings other than capital gains to its United States shareholders,

they are subject to a 15% Canadian withholding tax, which is really a tax against the recipient of the dividend, but each such recipient can then either deduct this tax in computing his own personal U. S. income tax or can take a credit for it against his own U. S. tax.

An American investment company, on the other hand, which owns exclusively Canadian securities, would find first that the dividends it received from its Canadian investments are subject to 15% withholding by Canada and, secondly, that its capital gains are subject to U. S. tax, unless the company comes under Supplement Q and its gains are distributed as provided therein. Assuming that the American company is a regulated investment company under Supplement Q and distributes its earnings and capital gains to its stockholders, there is no 15% withholding on such distributions, but the amount available for distribution has already been reduced by 15% as a result of the Canadian withholding on the dividends received by the American company, and a stockholder of the American company cannot take any deduction or credit for this tax imposed against his company even though the company itself, if it has distributed its income and capital gain, cannot use the Canadian tax as a deduction or credit.

Thus, the Canadian investment company seems to have important tax advantages over its American cousin provided it can operate so as not to be engaged in trade or business in the United States. If it should be so engaged, its income from sources in the United States would be taxable by the United States, and many of the advantages of its being a Canadian company might evaporate.

An investment company, as defined in the Investment Company Act of 1940, cannot offer its securities in the United States unless registered under that Act. The first draft of the 1940 Act provided only for the registration of American companies. As a result, a foreign investment company was absolutely prohibited from publicly offering its securities in the United States.

Following suggestions of the investment company industry, however, changes were made in the draft so that Section 7(d) as finally enacted was made to read as follows:

> "No investment company, unless organized or otherwise created under the laws of the United States or of a State, and no depositor or trustee of or underwriter for such a company not so organized or created, shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to offer for sale, sell, or deliver after sale, in connection with a public offering, any security of which such company is the issuer. Notwithstanding the provisions of this subsection and of section 8(a), the Commission is authorized, 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 under this title and to make a public offering of its securities by use of the mails and means or instrumentalities of interstate commerce, 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 this title against such company and that the issuance of such order is otherwise consistent with the public interest and the protection of investors."

Until recently no foreign investment company made any serious attempt to obtain an order permitting it to register under the Act and offer its securities in the United States. However, in 1951 an existing open-end Canadian investment company filed an application for such an order, and since that time three other companies have filed applications for orders. The Commission has not yet acted definitively upon any of these applications, and since 1951 the Commission and its staff, together with some of these applicants, have been considering what "circumstances and arrangements", if any, can be imposed which will make it both legally and practically feasible effectively to enforce the Act against a foreign investment company and otherwise consistent with the public interest and the protection of investors. This is not as easy a problem as it might seem at first, for it involves not only construction of Section 7(d) itself, but also difficult concepts of international comity in the conflict of laws sense, the proper jurisdiction of United States courts under the Act, and the practical enforcement of the Act so as adequately to protect American investors in a Canadian investment company. In addition there is the problem of national pride which any country has in connection with the operation of corporations organized under its jurisdiction.

After considerable study of the problem, the Commission last winter worked up a memorandum of conditions which, if complied with by a Canadian investment company, it considered would make it legally and practically feasible to enforce the Act against such company.

Before discussing these conditions, I would like to point out that the quoted language of Section 7(d) is susceptible of many

interpretations. If it is strictly construed to mean that unless the Act in all its aspects can be enforced literally against a foreign investment company and its officers, directors, underwriters, investment advisors and other affiliates wherever located and wherever their contracts may be entered into, then it is patently impossible for the Commission to evolve circumstances and arrangements which will have this result. The Commission, however, has proceeded on the premise that this is not the intended meaning of Section 7(d) but that instead the Commission is authorized under this language to work out circumstances and arrangements which, although they may not make it possible to enforce every aspect of the Act against a foreign investment company, its foreign directors, officers, affiliates, and investment advisors, will make it possible to enforce the Act in all respects against the company itself, and at the same time, so far as the others are concerned, will create liabilities consistent with the public interest and the protection of investors.

Section 44 of the Act gives the state and Federal courts concurrent jurisdiction in all actions at law and suits in equity brought to enforce the Act, or to enjoin any violations of the Act or of the rules thereunder. Suits to accomplish these purposes and to rectify gross abuse of trust by directors, officers, investment advisors and principal underwriters may be instituted in Federal courts by the Commission itself. Stockholders and certain others apparently may enforce the Act and enjoin its violation by suits in either Federal or state courts. Section 42(e) provides that in any proceeding to enforce compliance with Section 7 the court may take

jurisdiction and possession of the investment company and its assets, and appoint a trustee who, with the court's approval, may dispose of its assets subject to such terms and conditions as the court may prescribe.

Applicability of the Act to a Canadian investment company itself would seem to follow from its registration and the required agreement in connection therewith to be bound by the Act. Practical enforcement against the company should be possible as a result of its appointment of an agent in the United States for service of process against the company (which should give United States courts jurisdiction _in personam_), the maintenance of its assets in the hands of a United States bank custodian, and the requirement that a majority of its directors and officers be United States citizens, both of which I shall discuss later. These latter requirements should ensure that any violation of the Act so far as the company is concerned would be subject to the jurisdiction of United States courts, and that such jurisdiction would be exercised.

Enforcement of the Act to permit cash recoveries against foreign directors, officers, investment advisors and affiliates presents a much more difficult problem because of the legal concept that a country's legislation normally has no effect on foreigners in their transactions abroad. Therefore, unless some special arrangements are worked out, transactions occurring in Canada between the company and its Canadian officers, directors, investment advisor, or affiliates, would probably not be governed by the Act so far as such persons are concerned.

In considering the special arrangements, protection of the American investor is necessarily paramount. The Commission and stockholders must be in a position to enforce the stockholders' rights under the Act

against the company and so far as practical to enforce the Act through the company or otherwise against Canadian directors, officers, investment advisors or affiliates who have engaged in a transaction in violation of the Act. In general this means that monetary redress must be practically available.

Bearing all of the foregoing in mind, the staff of the Commission last February sent a memorandum to the Canadian companies who had filed applications under Section 7(d), whose purpose was to outline the conditions considered necessary for the granting of a favorable order. The most onerous of these conditions were that the foreign company maintain an office and its books and records in the United States; that it conduct its affairs so far as possible in the United States; that it appoint as custodian and maintain with a United States bank all of its assets; and that at least a majority of its directors and officers be United States citizens resident in the United States or Canadian citizens resident in the United States. In addition, there were requirements that the applicable provisions of the Investment Company Act be written into the charter or by-laws of the Canadian company, that the company's principal underwriter be an American citizen resident in the United States, that applicant, its officers, directors, and investment advisor appoint an attorney for service of process in the United States, and that a provision be included in the charter or by-laws permitting liquidation of the company's assets and distribution thereof to shareholders at the instance of a stockholder or the Commission or a court in the event the Commission or the court discovered a violation of the Section 7(d) order.

One of the investment companies which has filed an application for an order has now amended its application to comply fully with these conditions, and the Commission as newly constituted last summer will shortly have an opportunity to consider this application. The other applicants have not as yet been willing to comply with the specified conditions or are in the process of doing so.

The Commission as reconstituted during the summer requested the staff to prepare a rule for the registration of Canadian investment companies embodying the above conditions with such modifications as the staff considered advisable. Such a rule is now in the final stages of preparation.

The conditions developed by the staff were designed among other things to reduce to the minimum the type of transactions involving the company which can take place entirely outside the United States. This has been accomplished by requiring that the company maintain all of its assets in the United States in the custody of a United States bank, and by further requiring in substance that all of its transactions with directors, officers, investment advisors and affiliates employ the United States mails or means of interstate commerce. With all of the company's assets in the hands of a United States custodian, it will be almost impossible as a practical matter for any of such assets to be

expended, sold or otherwise disposed of without employment of the United States mails or the instrumentalities of interstate commerce. If an illegal transaction occurs with a Canadian director, officer, investment advisor or affiliate, he will be in violation of the Act without consideration of its extraterritorial application.

As a substitute for keeping all assets in the United States it has been suggested that only so much of the company's assets as are represented by the share holdings of American stockholders should be kept in custody in this country, and that the requirement with respect to United States citizens on the board of directors be curtailed. It seems doubtful whether a receiver appointed by a United States court and directed to liquidate the company's assets in this country could successfully operate unless he had subject to his control all of the company's assets. It seems doubtful that such an American receiver could successfully get possession of assets in Canada because the local process of ancillary administration would not operate across a country boundary in a case where the company concerned had been organized in the other country. Furthermore, all stockholders--both Canadian and American--would have a pro-rata interest in all assets, whether located in Canada or the United States, and it would be impractical for an American receiver to distribute part of the assets to Canadian stockholders without knowing whether the American stockholders, whom it is the intent of

the Act to protect, will be able to get their share of the assets in Canada. Thus, from the standpoint of enforcement, it is doubtful that the concept of a split custody of assets is sound.

The requirement that the majority of the directors be United States citizens (which as now conceived is somewhat different from the proposal last February) is designed to ensure enforceability of the Act against the company and to offer the means by which action by the company abroad might be compelled. In Steele v. Bulova Watch Company, decided by the United States Supreme Court in December 1952, it was held that a United States citizen who violated our trademark laws in Mexico could be liable in a civil action brought by the United States corporation whose trademark had been violated. This means that the trademark laws have extraterritorial effect so far as they pertain to a United States citizen, and likewise it would seem that the Investment Company Act may have extraterritorial effect so far as it applies to a United States citizen irrespective of any special arrangements of the type under discussion.

In view of the tax aspects of Canadian investment companies and the fact that the tax advantage may be lost if the company is deemed to be engaged in a trade or business in the United States, serious consideration is now being given by the staff to the elimination of the condition that the Canadian company maintain an office here and make its investment decisions here. Both of these requirements were, of

course, designed to bring the transactions of the company within the jurisdiction of a United States court. However, it would seem that jurisdiction over the subject matter can exist without these additional incidents.

My subject has been a complicated one, and I am sure you appreciate that it has no easy solution. The only real solution may lie in an amendment to the statute. Until that time, you must appreciate that the Commission and the staff, although it recognizes that some of the suggested conditions seem unduly burdensome and unreasonable, has no authority except as provided in the present Section 7(d). It is bound by the existing legislation, and while such legislation continues, its approach to the problem must necessarily be along the lines I have mentioned today.