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Recent years have witnessed two important trends in the securities markets—institutionalization and internationalization. The focus of this paper is the interaction of these two phenomena—in particular, the investment by three major classes of United States institutional investors in securities of foreign issuers, the legal or other obstacles that may be inhibiting cross-border investment, and the implications of a substantial increase in transnational investment.

The three types of institutional investors examined are those which are the most prominent in the equity markets—mutual funds, pension funds, and insurance companies. As of March 31, 1992, pension funds held approximately $2,563 billion in financial assets (of which private pension funds accounted for approximately two-thirds), insurance companies held approximately $2,096 billion (of which more than 70% was held by life insurance companies), and mutual funds held approximately $1,483 billion.

There are no authoritative figures available to indicate the percentage of investment in non-U.S. securities. However, figures or estimates supplied by the trade associations or regulatory agencies indicate that mutual funds have approximately 5% of their assets invested abroad, private pension funds approximately 5%, and life insurance companies approximately 2%.

I. REGULATORY STRUCTURE

In view of the relatively small amount of investment in foreign stocks and bonds by these three groups of institutions, it is appropriate to examine the regulatory structures governing them to ascertain the extent to which those regulations may be directly or indirectly inhibiting foreign investment.

A. Mutual Funds

Mutual funds are regulated by the U.S. Securities & Exchange Com-

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mission under the Investment Company Act of 1940 and provisions of other federal securities laws. The Investment Company Act does not limit the types of securities in which mutual funds can invest; it requires only that the fund follow the investment policy it has adopted and advertised to purchasers of shares in the fund.

The investment mix of mutual funds has changed greatly over the past twenty years. In 1968, 90% of mutual fund assets were invested in stock. In 1992, as a result of the rapid growth of bond funds, corporate stock accounted for only 47% of non-money market mutual fund assets, with U.S. government securities, tax-exempt state and local government obligations, and corporate bonds each accounting for between 15% and 18%.

In general, non-specialized equity and bond funds limit their investments to U.S. securities. However, there are a significant number of "international" or "global" funds managed by the major fund advisory organizations. "International" funds are those which invest solely in foreign securities; they may invest either in any foreign securities or only in the securities of a particular country or region. "Global" funds—which are usually bond funds—can invest in either U.S. or foreign securities, and vary their percentage of foreign investment depending on the prevailing interest rates in different countries and their expectations as to the future trend of the exchange rate between the U.S. dollar and the currency in which the bonds are denominated. The Investment Company Institute has estimated that approximately 2% of total mutual fund assets are in international funds and approximately 5% in global funds.

One factor inhibiting mutual fund investment in foreign securities is that the funds make a continuous offering of their shares at a price related to net asset value, and must therefore compute their net asset value daily (or more frequently). This means that any foreign security in which the mutual fund invests must be traded in an active market which provides current market prices through U.S. vendors and must be denominated in a currency that is freely convertible into U.S. dollars at a rate that is always ascertainable. Securities that do not meet these requirements can only be purchased by "closed-end" investment companies, which do not make continuous offerings of their shares and are less popular with investors.

B. Pension Funds

Pension funds fall into two categories—"private" pension funds, which cover non-governmental workers, and "public" pension funds, which cover employees of state and local governmental entities. The private pension funds are regulated by the Department of Labor under the Employee Retirement Income Security Act (ERISA); the public pension funds are exempt from ERISA and are regulated under the laws of the states in which they are located.

ERISA does not directly specify the kinds of securities in which pension funds may invest; it requires that the fund be managed by one or more "fiduciaries," who are required to invest fund assets (a) for the exclusive purpose of benefiting the participants in the plan, (b) with the degree of care that a prudent investor would use in the same circumstances, (c) by diversifying so as to limit the risk of large losses, and (d) in accordance with the instruments governing the plan. The diversification requirement would seem to support overseas investment; however, the question is whether such investments might be considered "imprudent." Courts interpreting the "prudence" test have not always been clear on whether the test applies to each security in which the fund invests or to the portfolio as a whole. If the test applies to each individual investment, it would be more difficult and/or more costly for the fiduciaries to obtain sufficient information about the foreign issuers to establish that they acted "prudently." As a result, foreign investment would be inhibited. On the other hand, if it applies to the portfolio as a whole, investment in a mix of foreign and domestic securities would be a prudent means of guarding the fund against a decline in the U.S. economy.

Private pension funds have always invested heavily in common stocks. In 1968, common stocks accounted for 60% of their assets. By 1992, that figure had shrunk to 47%, with U.S. government securities accounting for 15%, and corporate bonds accounting for 11%. State and local government funds were not traditionally investors in common stocks, having only 12% of their assets in stock in 1968. By 1992, however, that percentage had increased to 44% (almost on a par with private pension funds), with 28% in U.S. government securities and 22% in corporate bonds.

Private pension funds have invested substantial amounts in foreign securities, and recent studies indicate that many plan to increase foreign investment in the future. In many instances, management of the private pension fund is contracted out to professionals—investment advisers, banks, or insurance companies—that have the resources and the volume to make adequate investigation of foreign securities and issuers.

C. Insurance Companies

Insurance companies fall into two categories—life insurance companies and casualty insurance companies. As a result of an early Supreme

Court decision (which was overruled almost a century later) holding that insurance is not "commerce," insurance companies are regulated solely by the states. Even though many large insurance companies sell their policies on a nationwide basis, there is no direct regulation of insurance companies by the federal government.

State regulation of investment by insurance companies generally follows a "legal list" approach. A typical state insurance law spells out in detail the kinds of securities in which insurance companies can invest, ostensibly for the purpose of preventing them from making "unsafe" investments. Traditionally, life insurance companies, which enjoy special status under the income tax laws, have invested the major portion of their portfolios in corporate bonds and mortgages on real estate. On the other hand, casualty insurance companies, which are fully taxed on their investment income and generally not as tightly restricted with regard to the types of securities in which they can invest, have traditionally invested heavily in tax-exempt state and local government obligations and in corporate stock and bonds.

In 1992, life insurance companies had 40% of their assets invested in corporate bonds, 18% in mortgages on real estate, 16% in U.S. government securities, and only 7% in common stocks. Casualty insurance companies, on the other hand, had 25% of their assets invested in tax-exempt state and local government securities, 22% in U.S. government securities, 19% in common stocks, and 18% in corporate bonds.

With respect to investment in non-U.S. securities, the state laws generally permit investment of up to a specified percentage of the company's assets in certain non-U.S. securities which meet certain "quality" standards. For example, Section 1404 of the New York Insurance Law permits life insurance companies to invest their "reserve funds" in foreign securities "which are substantially of the same kinds, classes and investment grades as those [domestic] securities which are eligible for investment." However, life insurance companies are limited to investing not more than 10% of their assets in Canadian securities, and not more than 1% (in the aggregate) in all other foreign issues, except that if a company is conducting an insurance business in another country, it may invest in that country up to either (a) the amount which it is required by law to invest in that country, or (b) 1.5 times the amount of its reserves and other obligations under insurance contracts written in that country. California is more restrictive. Section 1194.6 of its Insurance Code permits an insurer to invest its "excess funds" in bonds and notes of foreign issuers only if the issuer is a wholly-owned subsidiary of a U.S. company and payment in full is guaranteed by the U.S. parent.

In recent years, there have been two major changes in the marketing strategy of life insurance companies, resulting in significant changes in their investment practices. First, starting in the 1950s, insurance companies began offering "variable" annuities and life insurance policies in which the payouts were not fixed but fluctuated depending on the performance of a portfolio of securities in a "separate account." These accounts are not subject to the investment restrictions found in the insurance laws. Further, they are generally heavily invested in equity securities. Second, life insurance companies are now much more involved in the pension and annuity business than in traditional life insurance. In 1990, approximately 49% of the premium income of U.S. insurance companies came from annuities, while only 29% came from life insurance, with the remaining 22% coming from health insurance. Of the annuity income, approximately 60% came from group annuities and pension plans. Because the group pension plan business is highly competitive, life insurance companies have become much more aggressive in their investment policies, investing heavily in high-yield, high-risk investments that enable them to offer pension plans at lower rates than their competitors. The recent bankruptcies of two large life insurance companies, attributable largely to the collapse of the market for high-yield corporate "junk" bonds in which they had heavily invested, has resulted in calls for tighter regulation of insurance company investments, possibly by the federal government.

II. OTHER INHIBITIONS TO INTERNATIONAL INVESTMENT

In addition to the laws and regulations that directly restrict the ability of U.S. institutions to invest in foreign securities and the ability of foreign institutions to invest in U.S. securities, there are other laws which indirectly impact such investment.

A. Taxes

The income tax laws of some countries provide for the withholding of taxes on dividends or interest paid to securityholders in other countries. This withholding may make foreign investments less attractive than domestic investments with comparable yields.

B. Disclosure

Provisions added to the Securities Exchange Act in 1968 require reports from any person or institution which acquires more than 5% of the stock of any publicly-traded U.S. corporation. While this would not necessarily inhibit foreign institutions from taking equity positions in the large U.S. companies, it might well inhibit their investment in smaller companies, where they would need to acquire more than 5% to make an investment sufficient to justify their costs in investigating the issuer's potential.

C. Liquidity

In making investments, most institutions are concerned with liquidity—the ability to dispose of the security in the market if their investment objectives or portfolio strategies change. Generally, the institutions will want to dispose of securities in the markets with which they are familiar and in which they have confidence. For U.S. institutions, this usually means the New York Stock Exchange or the NASDAQ system in the case of stocks, and the U.S. dealer market in the case of bonds. However, under the U.S. Securities Exchange Act of 1934, securities of non-governmental issuers can be publicly offered and traded in the U.S. only if they are registered with the Securities & Exchange Commission (SEC), which requires that the issuer provide financial and other information in the form specified by the SEC. Many foreign issuers are unwilling to subject themselves to these disclosure requirements, and consequently do not take the steps necessary to permit their securities to be publicly traded in the U.S.

To alleviate this problem, in 1990, the SEC adopted Rule 144A, which permits the trading of securities without requiring any disclosure by the issuer as long as all sales of the securities are made to qualified large institutions—generally defined as institutions with more than $100 million in investments. This rule, which applies to any class of securities not listed on a U.S. stock exchange or the NASDAQ system, has reportedly resulted in a significant increase in sales of foreign securities to U.S. institutions.

U.S. issuers may also be deterred from making offerings of their securities to foreign institutions if they are required to comply with disclosure requirements that apply when making an offering in the U.S. In 1964, the SEC issued a release setting forth the conditions under which a U.S. issuer could make an offering overseas without complying with the Securities Act of 1933. Regulation S, adopted by the SEC in 1990, elaborated and codified these conditions, making it easier for U.S. issuers to tailor offerings for the Eurobond and other overseas markets.

III. TRANSNATIONAL MARKETING OF INVESTMENT SERVICES

An alternative to transnational investment by institutions is to permit institutions to market their services in other countries. For example, an individual U.S. investor wishing to invest in a portfolio of securities of companies located in a particular country or region could invest either in a U.S. mutual fund concentrating on investments in that country or region, or invest in a fund based in that country or region which invests in its own "local" securities. Thus far, however, the opportunities for using the latter method have been limited.

A. Mutual Funds

Because of the significant differences between the way in which mutual funds are regulated under the U.S. Investment Company Act of 1940 and the ways in which comparable funds are regulated in other countries, it is virtually impossible for a fund organized in any foreign country (except Canada) to obtain the necessary authorizations to offer its shares in the United States. The U.S. requirements with respect to management fees and other charges, and the major role assigned to independent directors, are so different from the regulatory approaches followed in Europe and Asia that foreign funds find it very difficult to comply with them. In May 1992, however, the SEC issued a staff report recommending that the Investment Company Act be amended to permit the SEC to enter into bilateral understandings with fund regulators in other countries, and to make it easier for foreign funds to market their shares in the U.S.

With respect to investments in U.S. securities by residents of other countries, at the present time Germany and Switzerland are the only countries in which U.S. mutual funds can effectively market their services. One large U.S. fund adviser obtained permission in 1991 to sell mutual fund shares in Japan, but with the proviso that it could only sell funds specially designed for the Japanese market (not its regular well-known funds) and could only market its shares through brokers, rather than through the direct sales techniques heavily utilized in the United States. Further, the SEC's long legal battles with Geneva-based Fund of Funds in the 1960s and 1970s indicate that the Commission would not look favorably on "offshore" funds established to market shares of U.S. mutual funds.

B. Insurance Companies

Life insurance companies and casualty insurance companies, both in the U.S. and other countries, have been expanding their foreign activities aggressively in recent years, not by direct sales but by establishing or acquiring foreign insurance companies. In 1988, the latest year for which figures are available, the premium and investment income of U.S.-owned life insurers in other countries amounted to more than $9 billion. In 1989, foreign-owned insurers had premium income of $22.6 billion from sales in the U.S., accounting for about 6% of the total. With respect to casualty insurance, U.S.-owned companies had $16.2 billion of sales in foreign markets in 1988, and foreign-owned companies had $32.8 billion of sales in the U.S. in 1989, accounting for about 15% of the total. This percentage is expected to increase significantly due to the recent purchases of several large U.S. insurance companies by foreign interests.

The purchase of a U.S. insurer by a foreign insurer, or vice versa, does not necessarily increase the amount of transnational investment in portfolio securities by the individual companies themselves. However, the growth in the number of foreign-owned U.S. insurers is likely to result in pressure on regulators to liberalize foreign investment by the U.S. subsidiaries, particularly in the country or region in which the parent company is located.

IV. IMPACT OF TRANSNATIONAL INVESTMENT BY INSTITUTIONS

As institutional investors have come to own an increasingly large percentage of the shares of major U.S. corporations, and to account for an increasingly large percentage of the trading in those shares, they have had a major impact on both the markets in which the shares are traded and the control structure of the corporations themselves.

A. Impact on the Market

Investment by institutions can create problems if the investing institutions come to dominate a market, or if they engage in trading practices which have a destabilizing effect. Studies of the sharp and sudden drops in the U.S. stock markets in 1987 and 1989 indicate that trading practices followed by some institutions, such as "program trading," "index arbitrage," and "portfolio insurance," may have signifcantly exacerbated market swings. While most of this type of trading was done by U.S. money managers, it was recently reported that Nomura Securities, the largest Japanese securities firm, had become a major program trader in the New York market. Ironically, Nomura Securities engages in very little program trading in the Tokyo market, where most program trading is done by large U.S. firms such as Salomon Brothers and Morgan Stanley. Reportedly, Nomura's reluctance to engage in program trading in Tokyo is attributable to the political unpopularity of the practice, which some Japanese have blamed for a large part of the decline of more than 50% in the Tokyo market since 1989.

Unusual rules governing particular classes of institutions can also have strange effects on stock markets. For a time, Japanese insurance companies, which were subject to regulations permitting them to pay dividends only out of realized income, were buying and selling U.S. stocks in large quantities for the purpose of "buying dividends." This practice involved buying the U.S. stock immediately before the record date for a dividend, then selling the stock immediately after the record date at the same price reduced by the amount of the dividend. On certain days, these transactions amounted to as much as one-third of the total reported volume on the New York Stock Exchange. While there was no attempt to manipulate stock prices — indeed, the whole purpose was to buy and resell at the same price (adjusted for the dividend) — the practice did result in distorting the volume of trading reported for individual stocks and for the market as a whole.

B. Impact on Corporate Issuers

As institutions have accumulated larger and larger percentages of the stock of major corporations—between 80% and 90% in many cases—there has been increasing concern about the role they are playing, and the role they should play, in "monitoring" corporate managements and improving the economic performance of U.S. industry. During the takeover binge of the 1980s, the willingness of institutions to tender their shares to corporate raiders facilitated the takeover and restructuring of many large companies, with mixed results. Proponents of takeovers point to increased efficiency at corporations which were subjected to, or threatened with, takeovers. Critics, however, emphasize the economic disruption that resulted when the economy turned down and the target companies, unable to service the mountains of debt that were piled on them to finance the takeovers, were forced to seek protection under the bankruptcy laws.

In any event, the demise of the "junk bond" market and other factors have greatly reduced the number of hostile takeovers. The debate has now shifted to the question of whether institutions should move away from the traditional "Wall Street rule"—i.e., if you don't like the way the management is running the company, sell the stock--and toward a more active role in trying to improve the performance of poorly-managed companies without waiting for the "shock therapy" of a takeover attempt.

The banks, insurance companies, and investment advisers who manage most private pension assets have shown little enthusiasm for taking a more active role in corporate governance questions. And indeed it is hard to see what is in it for them. The extra cost of undertaking that function would handicap them in the price-sensitive competition for fund management. In addition, the short-term orientation of most money managers and their clients discourages activities which will show results, if any, only in the long term. Finally, the pension plan fiduciaries to whom they market their services are often the corporate executives who strongly resist any expansion of the shareholders' role in corporate governance.

The groups of institutions which are least affected by these pressures are the state and local government pension funds, which are managed by government officials who can see political advantage in criticizing corporate managements and calling for improvements in governance structure. It is therefore not surprising that those funds, led by the California Public Employees Retirement System (CALPERS), have been the most active in seeking a larger voice for shareholders in basic corporate decisions.

Whether this pressure will result in any significant changes in corporate governance practices remains to be seen. Its significance for transnational investment, however, is that if foreign institutions come to own a significant percentage of the shares of major U.S. corporations, political pressures against an expanded institutional role in corporate governance, which might be viewed as a kind of foreign takeover of U.S. companies may be heightened. However, the experience of financial institutions in Japan and the European Community, which have traditionally taken a larger role in the management of companies in which they invest, suggest that a similar role for financial institutions in the U.S. may have beneficial effects and might improve the competitiveness of U.S. industry. Whichever way it plays out, the possibilities of this development are intriguing.