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SEC Proposes New Rule for Evaluating Foreign Depositories

By Chris Kentouris

The Securities and Exchange Commission has proposed extending the date for changes governing the safekeeping of mutual fund assets in overseas banks and suggested it may issue a new regulation, 17(f)7, about the custody of assets in foreign depositories.

Bowing to concerns from custodian banks, the commission suggested that fund managers be responsible for deciding whether to hold assets with a foreign depository, subject to information provided by custodian banks. However, in a surprise move, the SEC is also asking whether it should extend the criteria it has established for foreign depositories to transfer agents. Comments about the SEC's proposal are due July 15.

"Is it appropriate to treat transfer agents as eligible securities depositories? Should other requirements be added if a transfer agent is to be treated as a depository?" asked the SEC in its proposal. The commission also questioned whether it should require custodian banks and their mutual fund clients to win SEC approval for their use on a case-by-case basis.

The idea of monitoring foreign transfer agents drew signs of concern from several

custodian banks' representatives attending a global custody conference in New York City last week on minimizing settlement risk, sponsored by U.K. consultancy Thomas Murray. Said one custodian bank official of the SEC's proposal, "Are they crazy? Can you imagine our doing that in Russia, where there are hundreds of transfer agents scattered all over the country?"

Other conference attendees said transfer agents were hired and paid by issuers. Therefore, said one official, to presume that they would allow themselves to be investigated by outsiders was "ludicrous."

Thomas Kerwin, senior counsel of the Office of Regulatory Policy at the Securities and Exchange Commission's Division of Investment Management, who spoke at the conference, said the SEC's motivation behind asking whether foreign transfer agents should be scrutinized by global custodians is an extension of the role that many foreign depositories play and the fact that in some countries transfer agents have a "custodian role" similar to depositories.

"Australia's Chess system acts as a kind of central transfer agent and may perform a depository-like role by transferring legal

title instead of beneficial title for uncertificated securities," he said. "Likewise, Russian registrars perform a 'depository-like role' by holding in their books the only evidence of share ownership."

Custodian banks are concerned that by even suggesting that their oversight be extended to transfer agents, the SEC is muddying the waters in raising the issue of just what a depository is. In fact,

that adequately protects it against risks of using a foreign depository, or it could contract with the global custodian for the bank to provide an initial risk analysis and continuous monitoring of the fund. The global custodian would have to notify its client of any important changes in the condition of the foreign depository. In either case, the depository would have to meet some minimum requirements, including being subject to oversight, treating all participants equally, segregating client assets, providing periodic reports and undergoing periodic review.

A global custodian's risk analysis would include a discussion of the depository's expertise and market reputation, quality of services, financial strength, insurance arrangements, extent and quality of regulation or other independent examination, ratings, internal controls and other procedures for safeguarding investments and related protections. The global custodian would subsequently have to provide the fund manager with an ongoing assessment of the custody risks associated with the use of the depository.

Rule 17(f)7 is the culmination of a successful lobbying effort by the Association of Custodian Banks—a group of global

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—Securities and Exchange Commission proposal

Kerwin said the new proposed rules would extend the definition of a depository to include a transfer agent that transfers and holds uncertificated securities on the books of an issuer for market participants. If that were the case, said some, even U.K. registrars, which are legally responsible for maintaining changes of ownership, would fall under global custodians' oversight.

How fund managers and their global custodians should safekeep assets invested abroad has been debated the past

