

THE ASSOCIATION OF GLOBAL CUSTODIANS

June 18, 1999

**VIA AIR COURIER**

British Columbia Securities Commission  
Alberta Securities Commission  
Saskatchewan Securities Commission  
The Manitoba Securities Commission  
Ontario Securities Commission  
Office of the Administrator, New Brunswick  
Registrar of Securities, Prince Edward Island  
Nova Scotia Securities Commission  
Securities Commission of Newfoundland  
Securities Registry, Government of the Northwest Territories  
Registrar of Securities, Government of the Yukon Territory

c/o Daniel P. Iggers, Secretary  
Ontario Securities Commission  
20 Queen Street West  
Suite 800, Box 55  
Toronto, Ontario M5H 3S8

Claude St. Pierre, Secretary  
Commission des valeurs mobilières du Québec  
800 Victoria Square  
Stock Exchange Tower  
P.O. Box 246, 22nd Floor  
Montreal, Québec H4Z 1G3

**Re: Notice of Proposed Changes to National Instrument 81-102  
and Companion Policy 81-102CP**

Ladies and Gentlemen:

This letter is submitted on behalf of the Association of Global Custodians ("Association") in response to the Notice of Proposed Changes to National Instrument 81-102 and Companion Policy 81-102CP, published by the Canadian Securities Administrators ("CSA") on March 19, 1999 ("1999 Notice"). The Association recognizes that comments on the 1999 Notice were due by May 18, 1999, apologizes for its tardiness in submitting this letter, and respectfully requests that the CSA nonetheless accept and consider the views set forth herein.

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The Association is an informal coalition of nine United States banks that act as global custodians or sub-custodians for the assets of major institutional investors, including Canadian mutual funds.<sup>1</sup> On October 31, 1997, the Association submitted comments ("1997 Comment Letter") to the CSA on the June 27, 1997 Notice of Proposed National Instrument 81-102 and Companion Policy 81-102CP and Rescission of National Policy Statement No. 34 and National Policy Statement No. 39 ("1997 Notice").<sup>2</sup> The great majority of the suggestions in the 1997 Comment Letter have been adopted and are reflected in the 1999 Notice. The Association appreciates the consideration the CSA afforded to our views and the thoughtful approach to custody-related issues that is reflected in the 1999 Notice.

The Association has reviewed Part 6 ("Custodianship of Portfolio Assets") of the revised proposal in the 1999 Notice. Based on that review, the Association recommends that the CSA make

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1/ The members of the Association are:

The Bank of New York  
Bankers Trust Company  
Boston Safe Deposit and Trust Company  
Brown Brothers Harriman & Co.  
The Chase Manhattan Bank  
Citibank, N.A.  
Investors Bank & Trust Company  
The Northern Trust Company  
State Street Bank and Trust Company

One of the objectives of the Association is to encourage regulatory and legal policies that promote the efficient and effective provision of global custody services and the removal of barriers to transnational custody and investment. The Association seeks to accomplish these goals by, among other activities, participation in governmental and self-regulatory organization proceedings and communication and discussion with regulatory officials.

2/ The version of National Instrument 81-102 in the 1997 Notice is referred to herein as the "1997 Proposal."

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several further modifications to proposed National Instrument 81-102. Our comments are set forth below.

1. Assets That May Be Held Outside of Canada

Proposed Section 6.1(2)(b) states that portfolio assets of a mutual fund may be held outside Canada by the custodian or sub-custodian "if required to execute portfolio transactions of the mutual fund outside Canada." In contrast, the 1997 Proposal permitted portfolio assets to be held outside of Canada "if appropriate to facilitate portfolio transactions of the mutual fund outside Canada." The 1999 Notice contains no explanation of this change.

The Association urges that proposed Section 6.1(2)(b) be amended to conform to the 1997 language. We recognize that, in most cases, foreign investment requires foreign custody.<sup>3</sup> However, there continue to be countries in which it would be possible -- although not practical -- to take physical possession of securities certificates and remove them to Canada. It is unclear whether, by the words "required to execute portfolio transactions" the CSA mean to compel Canadian funds to transport physical certificates to Canada in these circumstances. It is, we believe, obvious that any such requirement would be ill-advised -- the delays and risks incident to obtaining and transporting physical certificates would render such securities significantly less liquid than if they were held in a depository or by a sub-custodian in the jurisdiction in which the securities trade.

In order to avoid confusion on this point, the words "if appropriate to facilitate portfolio transactions of the mutual fund outside Canada" should be re-instated.

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<sup>3/</sup> For example, with increasing frequency, securities have been de-materialized or immobilized and cannot therefore be removed from the jurisdiction in which they trade.

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2. Content of Custodian and Sub-Custodian Agreements; Payment of Fees

Proposed Section 6.4(3)(b) contains a provision that would prohibit a custody agreement from containing a "provision that requires the payment of a fee to the custodian or sub-custodian for the transfer of the beneficial ownership of portfolio assets of the mutual fund." This provision is unchanged from the 1997 Proposal. Proposed Section 6.5(5), which was not included in the 1997 Proposal, is a parallel prohibition against the payment by a mutual fund of a fee to a custodian or sub-custodian for the transfer of beneficial ownership of portfolio assets.

In contrast to the unqualified prohibition in proposed Section 6.4(3)(b), the comparable provision in National Policy Statement No. 39 ("NP 39") expressly permitted contractual provisions requiring payment of "the fees and expenses of the Custodian or sub-custodian as the case may be for safekeeping and administrative services."<sup>4</sup> It is common for custodians to charge an administrative and safekeeping fee which includes a charge for processing the receipt of assets into custody or the delivery of assets out of custody. Although such processing occurs as a result of purchases and sales by the mutual fund, these transaction-based fees compensate the custodian for performing a specific service, not for the transfer of beneficial ownership. Such fees have never been regarded as inconsistent with Section 7.01(8) of NP 39.

In order to avoid any possible confusion on this point, we recommend that proposed Sections 6.4(3)(b) and 6.5(5) be amended to conform to the language of NP 39 by adding at the end of each the words "other than for safekeeping and administrative services in connection with acting as Custodian or sub-custodian."<sup>5</sup>

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<sup>4/</sup> Section 7.01(8) of NP 39. We note also that the "no-lien" provision in proposed Section 6.4(3)(a) contains an exception for "a good faith claim of the custodian or sub-custodian for acting in that capacity." See also Section 7.01(7) of NP 39.

<sup>5/</sup> Similar language appears in the custody regulatory provisions under U.S. law. Rule 17f-5(c)(2)(i)(C) under the Investment Company Act of 1940 requires custody contracts to provide that "beneficial ownership for the Fund's assets will be

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### 3. Shareholders' Equity Requirement

Proposed Section 6.3 would require that a non-Canadian bank, trust company, or governmental entity that acts as a custodian of mutual fund assets must have shareholders equity in excess of \$100 million. Proposed Section 6.3 also contains a similar requirement applicable to affiliates of banks and trust companies. This shareholders equity requirement is consistent with the 1997 Proposal and with NP 39.

In the 1997 Comment letter, the Association recommended that the shareholders equity requirement be reduced from \$100 million to \$50 million. Alternatively, the Association suggested that, like the U.S. Securities and Exchange Commission, the CSA abolish the shareholders equity requirement for foreign custodians.<sup>6</sup> The 1999 Notice states that the CSA chose to continue the \$100 million requirement because "it retains the status quo that has been in effect for some time" and because the "CSA believe the limit is appropriate."<sup>7</sup>

The Association recommends that the CSA reconsider this issue and reduce or eliminate the shareholders equity requirement. As set forth in the 1997 Comment Letter, we believe that a \$50 million requirement would be more than adequate to protect fund shareholders, while at the same time permitting greater latitude in selecting the local banks best able to provide reliable service.<sup>8</sup>

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freely transferable without the payment of money or value other than for safe custody or administration." (emphasis added)

<sup>6/</sup> In lieu of a shareholders equity requirement, Rule 17f-5(c), supra note 5, requires that a finding be made that the foreign bank will afford "reasonable care" to fund assets, based on the standards of the local market.

<sup>7/</sup> 1999 Notice at 32. Page citations to the 1999 Notice are to 22 OSC Bulletin, Issue 11 (Supp) (March 19, 1999).

<sup>8/</sup> The shareholders equity test has the greatest impact in small or emerging markets where there may be few -- if any -- local banks providing custodial services that meet the requirement. In the absence of an eligible local custodian, a Canadian fund could

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We reiterate the point we made in 1997: The quality of the service offered by local custodians is, in our experience, more closely correlated with the caliber of the sub-custodian's personnel and the nature of the procedures and controls it employs than to the magnitude of its shareholders equity.

4. Indemnification

Proposed Section 6.6(3) provides that a mutual fund may indemnify a custodian or sub-custodian against legal fees, judgments, and amounts paid in settlement, if two conditions are satisfied:

- "(a) those fees, judgments and amounts were not incurred as a result of a breach of the standard of care described in subsection (1); and
- "(b) the mutual fund has reasonable grounds to believe that the action or inaction that caused the payment \* \* \* was in the best interests of the mutual fund." (emphasis added)

This provision is a considerable improvement over Section 4.3 of the 1997 Proposal. However, the Association continues to believe that, so long as the custodian has adhered to the standard of care imposed on it, its entitlement to indemnification should not be dependent on whether the action or inaction involved was in the best interests of the mutual fund.

As explained in our 1997 Comment Letter, custodians are obligated by contract to follow the instructions received from their clients, and are not empowered to exercise discretion. Therefore, where the custodian has followed the instructions

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be precluded from investing in an emerging jurisdiction, regardless of its assessment of the potential risks and rewards afforded by that market. Further, if shareholders equity is relevant to subcustodian selection at all, the issue should be the relationship between the amount of the subcustodian's shareholders equity and the value of the assets it holds in custody, not the absolute level of shareholders equity.

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received from the mutual fund and has acted with the requisite degree of care, it should be entitled to indemnification, even if, in hindsight, the mutual fund determines that the instructions that it or its investment adviser transmitted to the custodian were not in the best interests of the fund. Since a custodian must follow its client's instructions and has no discretion to assess the wisdom of those instructions, it would be highly unfair to require custodians to bear losses resulting from the due execution of instructions that the mutual fund later asserts were not in its best interests.<sup>9</sup>

For these reasons, the Association urges that the word "and" which joins clauses (a) and (b) of Proposed Section 6.6(3) be replaced by the word "or". Alternative, clause (b) should be deleted.

\* \* \* \*

The Association appreciates the opportunity to comment on proposed National Instrument 81-102. If there are questions

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<sup>9/</sup> The CSA correctly recognizes these points in the 1999 Notice:

Custodians are obligated by contract to follow instructions that are received from their clients and not empowered to exercise discretion such as contemplated by making a "best interests" determination. Also, a custodian is not in a position to determine what is in the best interest of the fund since few of the relevant variables are within its control (or even its knowledge).  
\* \* \* Where a custodian has not acted negligently, contracts do not normally require any additional showing to avoid liability." 1999 Notice at 30 (emphasis added).

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concerning the Association's views, please feel free to contact  
either the Chairperson of the Association --

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or the Association's counsel --

Daniel L. Goelzer  
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Washington, D.C. 20006  
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In accordance with the instructions in the 1999 Notice, we  
have enclosed a duplicate of this submission and a diskette on  
which the submission appears in WordPerfect 8.0 format. We have  
also forwarded copies by e-mail to Messrs. Iggers and St. Pierre  
and to each individual listed on page 21 of the 1999 Notice.

Sincerely,

*Association of Global Custodians*

The Association of Global Custodians  
By: Daniel L. Goelzer

cc (Via E-Mail):

Robert Hudson  
Manager and Senior Legal Counsel  
Noreen Bent  
Senior Legal Counsel  
Wayne Redwick  
Director, Corporate Finance  
British Columbia Securities Commission

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The Chase Manhattan Bank

Members of the Association's  
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State Street Bank and Trust Company

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Principal and Counsel  
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Maura Doherty  
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