THE ASSOCIATION OF GLOBAL CUSTODIANS

October 31, 1997

**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

Jacques Labelle, General Secretary
Commission des valeurs mobilières du Québec
800 Victoria Square
Stock Exchange Tower
P.O. Box 246, 17th Floor
Montreal, Québec H4Z 1G3

**Re: Notice of Proposed National Instrument 81-102CP and Rescission of National Policy Statement No. 34 and National Policy Statement No. 39**

Ladies and Gentlemen:

This letter is submitted on behalf of the Association of Global Custodians ("Association"), an informal association of ten United States banks that act as global custodians or sub-custodians for the assets of major institutional investors, including as sub-

custodians for Canadian mutual funds.[1] Indeed, we believe that members of the Association hold custody of a substantial percentage of the non-Canadian assets of Canadian mutual funds.

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. Accordingly, the Association has reviewed the June 27, 1997 Notice of Proposed National Instrument 81-102CP and Rescission of National Policy Statement No. 34 and National Policy Statement No. 39. Our review has been limited to Part 6 ("Custodianship of Portfolio Assets") of Proposed National Instrument 81-102 and to certain provisions of Part 4 ("Conflicts of Interest") and Part 5 ("Approvals For and Disclosure of Certain Changes") which may affect custodians. Our comments concerning these provisions are set forth below.

1. Contractual Limitations on Liability and Indemnification Clauses

Proposed Section 4.3(1) would provide that an agreement between a mutual fund and a person or company with respect to the provision of services to the mutual fund may not relieve the service provider from liability to the fund for a loss suffered by

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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
Morgan Stanley Trust Company
The Northern Trust Company
State Street Bank and Trust Company

the fund "that arises out of an action or inaction" of the service provider, unless --

> "(a) The action or inaction did not constitute negligence or wilful misconduct by the person or company; and
>
> (b) The person or company, in good faith, determined that the action or inaction was in the best interest of the mutual fund." (emphasis added)

Proposed Section 4.3(2) contains a similar provision with respect to indemnification. Under proposed Section 4.3(2), a mutual fund's agreement to indemnify a service provider would only be enforceable where the service provider could show both that it had not acted negligently or engaged in wilful misconduct and that the service provider had determined that its action or inaction was in the best interests of the mutual fund.

In our view, clauses (a) and (b) of proposed Sections 4.3(1) and 4.3(2) should be in the disjunctive, rather than the conjunctive. If the service provider did not engage in negligent or wilful misconduct, it should not be necessary for it also to demonstrate that it determined that the "action or inaction" in question was in the best interest of the mutual fund. Conversely, if the service provider can affirmatively demonstrate that it was acting in what it had determined to be was the best interest of the fund, it should not be required to also demonstrate that its action was not negligent and that it had not engaged in wilful misconduct.[2]

The difficulty in making a "best interest" determination is especially acute in the case of a mutual fund's global custodian.[3]

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[2] Moreover, it seems unlikely that action taken based on an actual determination that it was in the best interest of the fund would nonetheless be found to have been "negligent."

[3] In these comments, we use the phrase "global custodian" to refer to the bank that, as a sub-custodian to a Canadian mutual fund, provides custody services to the fund through a network of sub-sub-custodians in jurisdictions outside of Canada. See note 4, infra.

Global custodians typically process large volumes of transactions on behalf of their clients in accordance with standardized procedures. Further, custodians are obligated by contract to follow the instructions received from their clients, and are not empowered to exercise discretion. Therefore, the custodian has no ability or authority to make determinations concerning whether the actions it has been instructed to take are in the best interest of its client.

Contractual arrangements between mutual funds and their custodians generally do recognize that the custodian is obligated to exercise reasonable care and will be liable for losses resulting from the failure to do so (i.e., losses resulting from negligence).[4] Where the custodian has not acted negligently, however, such contracts do not normally require any additional showing in order to avoid liability.

As noted above, this concern could be solved by changing the word "and" which joins clauses (a) and (b) in proposed Sections 4.3(1) and 4.3(2) to the word "or." Alternatively, if the Canadian Securities Regulators ("CSA") believe that other types of service providers should be required to make both of the showings required by the proposed language of Sections 4.3(1) and 4.3(2), we would suggest that a separate provision applicable specifically to custodian liability be created.

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[4] Global custodians generally also assume responsibility for losses resulting from the negligence (relative to local market standards) or wilful misconduct of sub-custodian banks selected by the global custodian. The major global custodians maintain networks of foreign sub-custodians and exercise due diligence over the procedures and controls of their network members. However, in those cases were the mutual fund instructs the global custodian to use the services of a specific sub-custodian in a particular jurisdiction that is not otherwise part of the global custodian's network, the global custodian would normally refuse to assume any responsibility for losses resulting from the activities of that entity. Where the global custodian has no control over the decision to place and maintain assets with a particular sub-custodian, it would obviously be unfair to expect the global custodian to assume liability for the negligence or misconduct of that sub-custodian.

2. Delegation of Authority to Sub-Custodians

Section 6.1(3)(a) would provide that a custodian or sub-custodian of a mutual fund may delegate custodial authority to one or more sub-custodians, if --

"for each delegation

(a) written consent to the delegation has been provided by the mutual fund and, if the delegation is by a sub-custodian, the custodian of the mutual fund * * * ."

Typically, a global custodian enters into a contract with its mutual fund customers that authorizes the global custodian to place assets with sub-custodians. In most cases, the global custodian maintains a network of sub-custodians throughout the world. In each jurisdiction in which the mutual fund requires custody services, the global custodian routinely places the fund's assets with its network member.[5] While the contract between the global custodian and the mutual fund may specify the mechanism by which the mutual fund notifies the global custodian of the fact that an investment has been made (and custody services are therefore required), in a jurisdiction in which the fund has not previously held assets, it is not typical to provide for separate "written consent" to the appointment of a sub-custodian in each new jurisdiction. We believe that, assuming the global custody contract provides for the placement of assets in new jurisdictions as investments occur, separate, country-by-country, written consents would constitute a needless paperwork burden and would serve no investor protection purpose.

For these reasons, we suggest that the words "(which may be in the form of a general consent in the contract governing the relationship between the mutual fund and the custodian)" be inserted after the words "written consent" in Section 6.1(3)(a). This change would make clear that separate, country-by-country consents are not required where the appointment of a sub-custodian is consistent with the contract between the mutual fund and its global custodian.

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[5] See note 4, supra.

3. Foreign Subsidiaries

Proposed Section 6.3 would set forth the entities eligible to act as foreign sub-custodians for Canadian mutual funds. In essence, such an entity must be --

(1) a Canadian bank, trust company, or a subsidiary of such a bank or trust company (see Section 6.3, paragraph 1);

(2) a non-Canadian bank or trust company with shareholders equity in excess of $100 million (see Section 6.3, paragraph 2); or

(3) a wholly-owned subsidiary of an entity described in (1) or (2) as to which "all of the custodial obligations of the subsidiary in respect to that mutual fund are fully and unconditionally guaranteed by the entity referred to in" (1) or (2) (see Section 6.3, paragraph 3).

Paragraphs 2 and 3 of this provision raise several issues.

a. Percentage of Subsidiary Ownership

The inclusion of the "wholly-owned" requirement in paragraph 3 of proposed Section 6.3 is unnecessary. While we recognize that this is an element of existing National Policy Statement No. 39, it excludes from eligibility the subsidiaries of major bank holding companies that are sister affiliates, rather than direct subsidiaries, of an eligible bank. Further, it excludes subsidiaries of eligible banks that are not wholly-owned by their parent. Controlled subsidiaries that are not wholly-owned are common in international banking. In fact, in some countries, legal requirements or custom dictate that a local resident must have an ownership interest in a domestic bank; such provisions preclude foreign banks from creating wholly-owned subsidiaries.

In our view, there is no regulatory reason to continue to prevent sister-affiliates or less-than-wholly-owned subsidiaries of eligible banks from acting as custodians of the foreign assets of Canadian mutual funds. Given the frequency with which the foreign custody networks of the major global custodians include affiliates that are not wholly-owned subsidiaries of the eligible bank that is a member of the global custody group, these requirements limit the

ability of global custodians to place Canadian mutual fund assets with the best available sub-custodian in securities markets outside of Canada. We believe that the primary protection for Canadian shareholders with respect to affiliates of eligible banks arises from a requirement that, if the subsidiary lacks sufficient shareholders' equity, the eligible bank must assume financial responsibility for losses. The percentage of parent ownership or the nature of the corporate organization chart are of far less significance.

For these reasons, we recommend that the words "wholly-owned" be deleted from paragraph 3 of Section 6.3 and that the word "subsidiary" be replaced with the phrase "subsidiary or affiliate."[6]

b. Unconditional Guarantee Requirement

Paragraph 3 of proposed Section 6.3 would also require that the custodial obligations of the subsidiary in respect of the mutual fund be "fully and unconditionally guaranteed" by the eligible parent. Many bank regulatory authorities have not addressed the implications of custodial obligations of affiliates that are "fully and unconditionally guaranteed" by a bank, and it is possible that, in some jurisdictions, it may eventually be determined that such guarantees trigger reserve requirements or regulatory restrictions on the ability of a bank to issue a third-party guarantee.

Exemptive orders issued by the U.S. Securities and Exchange Commission in this situation have generally required only that the eligible bank "assume liability for" the obligations of the subsidiary or for losses resulting from the use of the subsidiary to the same extent as if the eligible bank had itself held the assets. From the standpoint of shareholder protection, we believe that there is little or no substantive difference between such an assumption of liability and an "unconditional guarantee." We suggest that clause (b) of paragraph 3 of Section 6.3 be reworded to require that the parent bank "assume liability for" losses occurring as a result of the custody activities of the subsidiary to the same extent as if the parent had held the assets.

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[6] A parallel change in paragraph 3 of Section 6.2 may also be appropriate.

c. Shareholders' Equity Requirement

The Association also believes that the shareholders' equity requirement in paragraphs 2 and 3 of Section 6.3 should be reduced from $100 million to $50 million. While we appreciate that setting the level of shareholders' equity required to establish eligibility to hold mutual fund assets is to some degree an arbitrary exercise, the experience of the members of the Association suggests that, in smaller or emerging markets, the $100 million requirement excludes most -- or, in some cases, all -- potential local custodian banks. We believe that, particularly in such markets, 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. 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.[7]

4. Omnibus Accounts

Proposed Section 6.5(1) would require that --

"* * * [P]ortfolio assets of a mutual fund not registered in the name of the mutual fund shall be registered in the name of the custodian or a sub-custodian of the mutual fund or any of their respective nominees with an account

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[7] Alternatively, consideration should be given to dispensing with the shareholders' equity requirement. The U.S. Securities and Exchange Commission has recently amended its mutual fund foreign custody rule, Investment Company Act Rule 17f-5, to eliminate the requirement that the foreign bank custodian satisfy a shareholders' equity test. In lieu thereof, Rule 17f-5 now requires that an affirmative finding be made that the foreign bank will afford "reasonable care" to fund assets, as determined based on the standards of the local market. The Association supported this change and believes that an analysis of the level of protection afforded by a foreign bank provides greater security to mutual fund shareholders than does the mechanical application of a shareholders' equity standard.

> number or other designation in the records of the custodian or sub-custodian or the applicable nominee sufficient to establish that the beneficial ownership of the portfolio assets is vested in the mutual fund."

Similarly, proposed Section 6.5(4) would require that --

> "The custodian or sub-custodian of a mutual fund arranging for the deposit of portfolio assets of a mutual fund with * * * a depository or clearing agency which is authorized to operate a book-based system shall ensure that the records of either the participant in the book-based system or the custodian or sub-custodian of the mutual fund or the respective nominees establish that the beneficial ownership of the portfolio assets is vested in the mutual fund."

We are concerned that in some situations these provisions could be construed to cast doubt on the use of omnibus accounts to hold the assets of Canadian mutual funds. Because such accounts are extremely common in the global custody industry, we believe that any doubt concerning this issue should be eliminated.

In an omnibus account arrangement, the assets of all of a particular custodian's customers may be held in a single account at a sub-custodian bank or at a depository. These accounts typically carry names such as "XYZ Bank, Custodian, for the Account of its Customers." In our view, this type of account is sufficient to establish that beneficial ownership is not in the custodian bank itself. However, in order to determine what part of the assets belong to any particular mutual fund or other bank customer, reference must be made to the records of the global custodian. Where a global custodian maintains an omnibus account with a local sub-custodian bank and the local sub-custodian bank, in turn, maintains an omnibus account at a depository, neither the records of the depository nor the records of the sub-custodian bank will be sufficient to determine which assets belong to a particular mutual fund for which the global custodian acts.

To address this issue, we suggest that, in proposed Section 6.5(1), the words "or sub-custodian or the applicable nominee" be deleted so that the final clause would read:

> "* * * [P]ortfolio assets of a mutual fund not registered in the name of the mutual fund shall be registered in the name of the custodian or a sub-custodian of the mutual fund or any of their respective nominees with an account number or other designation in the records of the custodian sufficient to establish that the beneficial ownership of the portfolio assets is vested in the mutual fund."

Similarly, we suggest that, in Section 6.5(4), the words "or sub-custodian of the mutual fund or the respective nominees" be deleted so that the final clause would read:

> "The custodian or sub-custodian of a mutual fund arranging for the deposit of portfolio assets of a mutual fund with * * * a depository or clearing agency which is authorized to operate a book-based system shall ensure that the records of either the participant in the book-based system or the custodian establish that the beneficial ownership of the portfolio assets is vested in the mutual fund."

These changes would make clear that, regardless of the form of account at the sub-custodian and depository level, ownership of the assets is properly recorded as long as the global custodian's records identify the assets that belong to each particular mutual fund customer of that global custodian.

* * * *

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

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

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In accordance with the instructions in the June 27, 1997 notice, we have enclosed a duplicate of this submission and a diskette on which the submission appears in WordPerfect Windows 6.1 format.

Sincerely,

Association of Global Custodians

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