THE ASSOCIATION OF GLOBAL CUSTODIANS

THE BANK OF NEW YORK
BANKERS TRUST COMPANY/DEUTSCHE BANK
BROWN BROTHERS HARRIMAN
THE CHASE MANHATTAN BANK
CITIBANK, N.A.
INVESTORS BANK & TRUST COMPANY
MELLON TRUST/BOSTON SAFE
DEPOSIT & TRUST COMPANY
NORTHERN TRUST COMPANY
STATE STREET BANK AND TRUST COMPANY

COUNSEL TO THE ASSOCIATION:
BAKER & MCKENZIE
815 CONNECTICUT AVENUE, N.W
WASHINGTON, D.C. 20006

TELEPHONE: 202/452-7013
FACSIMILE: 202/452-7074

June 5, 2000

VIA AIR COURIER

Sitaren Sita
Senior Insurance Officer
Monetary Authority of Singapore
10 Shenton Way
Authority Building
Singapore 079117

RE: Proposed Amended Guidelines for Custody Arrangements for Insurance Fund Assets

Dear Mr. Sita:

This letter is submitted on behalf of the Association of Global Custodians ("Association") in response to the proposed Requirements for Custody Arrangements for Insurance Fund Assets recently published by the Monetary Authority of Singapore ("Authority"). The Association is an informal group of nine U.S. banks that are major providers of global custody services to institutional investors throughout the world. Accordingly, these proposals are of considerable interest and importance to the Association.

The Association generally supports the Authority's efforts to define the structure applicable to custody of insurance fund ("Fund") assets. The Association initially reviewed the version of the Authority's guidelines that was made available to us in March, 2000 ("Original Guidelines"). The Authority subsequently revised these guidelines to address various comments it had received, and we have also reviewed the amended version that the Authority released in late April ("Amended Guidelines"). The Association believes that the Amended Guidelines are a

substantial improvement over the Original Guidelines. In some respects, however, we believe that further changes are needed to conform the Amended Guidelines to modern custody practice in other comparable financially sophisticated jurisdictions. Our comments and recommendations are set forth below.

Responsibilities of Insurer's Board

Paragraphs 1.1 and 1.2 of the Original Guidelines seemed to place the responsibility for establishing and monitoring custody and subcustody arrangements with the board of the insurer or an authorized committee of the board. In contrast, Paragraph 1.3(b) of the Amended Guidelines provides that the insurer may rely on a custodian to ensure that the requirements of the Amended Guidelines are met with respect to subcustodians, provided the insurer determines that the custodian has a proper system in place to monitor subcustodian appointments.

While not completely clear, we assume that Paragraphs 1.1, 1.2, and 1.3 of the Amended Guidelines, read together, are intended to permit boards to delegate the selection and monitoring of subcustodians to the Fund's primary custodian. The Association supports this result and urges that the Authority make clear that such a delegation is permitted. In the Association's view, requiring board action on the details of subcustody arrangements, including the selection and replacement of subcustodians, would not be in the best interests of insurers or policyholders. Typically, directors of investment funds are not expert in evaluating potential subcustodians or in structuring subcustody arrangements, especially in foreign jurisdictions. Therefore, as a practical matter, directors must rely on the recommendations of their global custodian concerning these matters.[1]

1/ As you may be aware, in 1997, the United States Securities and Exchange Commission ("U.S. SEC") amended its regulations governing custody of U.S. investment company assets to permit such delegations. Rule 17f-5 permits the board of an investment company to delegate the selection and monitoring of subcustodians to a bank (e.g., the investment company's custodian), provided that the board determines that it is reasonable to rely on the delegate, requires the delegate to provide certain written reports to the board concerning custody

Application of the Selection and Contract Provisions to Securities Depositories

Paragraph 4(b) of the Amended Guidelines provides that the portions of the Amended Guidelines relating to the selection of custodians and the content of custody contracts also apply to the "appointment" of securities depositories "to the extent that it is reasonably achievable." Paragraph 4(b) also states that the "custody arrangement with Securities Depositories should have alternate reasonable safeguards in lieu of those provisions above that cannot be achieved."

While we appreciate the Authority's recognition that the selection and contract provisions cannot mechanically be applied to securities depositories, we do not believe that the concept of alternate reasonable safeguards is a workable solution to this problem. We recommend that the Authority, like several other regulatory bodies, including the Australian Prudential Regulatory Authority and the Canadian securities regulators, exclude securities depositories from treatment as custodians or subcustodians.[2] The use of securities depositories should not be governed by custody regulations for two reasons --

---

arrangements, and the delegate agrees to exercise reasonable care, prudence and diligence, or to adhere to a higher standard of care, in performing the delegated responsibilities.

2/ During 1999, the Australia Prudential Regulatory Authority ("APRA") adopted custody requirements for the assets of Australian insurance companies. APRA's rules expressly provide that securities depositories are not subcustodians: "Subcustodian includes an entity appointed by the Custodian to hold assets of the Custodian's client on its behalf but excludes securities depositories." See Custodian Requirements For APRA Supervised Entities, Section A (Definitions). This definition is also applicable in interpreting Policy Statements 130-133 of the Australian Securities and Investments Commission.

Similarly, the Canadian securities regulators recently completed a comprehensive revision of their rules applicable to Canadian mutual funds, including custody of mutual fund assets. The definition of an eligible foreign subcustodian in these rules does not include securities depositories. See Section 6.3 of National instrument NI 81-102. Moreover, the Canadian rules

- Unlike subcustodian banks, depositories cannot be "selected." On the contrary, the use of a particular securities depository is usually compulsory once a decision has been made to invest in securities that trade in the market served by that depository. Therefore, use of the depository follows automatically from the decision to invest in a security that is held at that depository, since it is rarely practical, and sometimes impossible, for an institutional investor to withdraw securities from a central securities depository and hold them in physical form.[3] The decision to invest in a security that trades in a particular market is tantamount to a decision to use that market's depository, and conversely a decision to refrain from using the depository can only be implemented by selling the securities that are held through it.

- It is not possible to negotiate with a securities depository concerning the terms under which assets are held. Therefore, the existence of contractual protections, such as those in Paragraph 3.1a of the Amended Guidelines, is not a workable requirement in the case of securities depositories. Most depositories do not enter into contracts with either participants or with the investors whose assets are held at the depository. Even if the rules and practices of a depository are viewed as the equivalent of a custody contract, individual participants have no ability to alter the depository's rules or to obtain modifications in order to conform to the custody regulatory requirements in the home country of particular investors whose assets are held at the depository. For this reason, custody

---

expressly state: "A custodian or sub-custodian of a mutual fund may deposit portfolio assets of the mutual fund with a depository, or a clearing agency, that operates a book-based system." Id., Section 6.5(3).

3/ Even where it is otherwise possible to do so, holding physical certificates is often inconsistent with market trading and settlement practices and would therefore render the security in question illiquid. This is increasingly the case as settlement times are compressed in response to the G-30 recommendations.

contract requirements, such as those in Paragraph 3.1a of the Authority's rules, cannot be applied to assets held at a depository.[4]

4/ As noted above, few, if any, depositories, by contract, rule, or otherwise, afford rights and protections comparable to those in Paragraph 3.1(a). For example:

- Contrary to Paragraph 3.1(a)(i), securities held at a depository are invariably commingled with fungible securities of other participants. Indeed, this is one of the defining characteristics of a depository.

- Contrary to Paragraph 3.1(a)(ii), securities held at a depository are typically registered in the name of the depository's nominee. Most depositories would simply find it impossible to permit securities to be held at the depository, if registered in any name other than the depository's nominee, regardless of whether or not the local jurisdiction recognized trust law concepts.

- Contrary to Paragraph 3.1(a)(i), depository records only identify the securities held in the depository as held for the account of the depository participant. Depositories generally cannot identify on their records the beneficial owner of the securities they hold.

- Contrary to Paragraph 3.1(a)(iv), depositories will not negotiate with individual participants concerning insurance coverage levels or indemnification. While some depositories carry insurance against losses, it is not uncommon for depositories to refuse to reveal the magnitude of the depository's insurance coverage.

- Contrary to Paragraph 3.1(a)(v), many depositories impose settlement liens on securities held through their facilities.

- Contrary to Paragraph 3.1(a)(vi), it would be rare for a depository to permit a non-participant or the independent accountants for a non-participant to examine the depository's records. We believe it is extremely unlikely that any non-Singaporean depository anywhere in

For these reasons, the best approach would be for the Authority to expressly exclude depositories from the application of the Amended Guidelines. A workable, although in our view less desirable, alternative would be to exclude depositories from the contract provisions and merely require that, in determining whether to invest in a particular jurisdiction, the insurer must weigh the risks associated with the local depository, along with other investment considerations. This is the approach recently adopted by the U.S. SEC.[5] This could be accomplished by revising Paragraph 4 to state:

> The above guidelines on the selection of custodians and requirements on custody contracts do not apply to the use of Securities Depositories. In the case of Securities Depositories, the Board must review the risks and benefits associated with the use of any Securities Depository through which Fund Assets will be held as part of deciding whether to invest in securities that will be held in the depository. After determining to invest, the Board must periodically monitor the appropriateness of maintaining Fund Assets with the Securities Depository. In performing such reviews and monitoring, the Board may rely on information provided to it by the Fund's custodian.

---

the world would agree to permit a foreign regulator, such as the Authority, to inspect its records.

5/ On April 27, 2000, the U.S. SEC adopted Rule 17f-7. Rule 17f-7 recognizes that securities depositories cannot be subject to the selection and evaluation procedures that apply to subcustodians under Rule 17f-5. Rule 17f-7 requires an investment company's global custodian to provide the fund or its adviser with an analysis of the custody risks of each depository used by the investment company. In addition, the global custodian must monitor the risks associated with use of each depository and promptly notify the fund of any material changes. See Investment Company Act Release No. 24424 (April 27, 2000), 65 FR 25630 (May 3, 2000). This release is available on the website of the U.S. SEC: www.sec.gov.

Application of Selection and Contract Provisions to Subcustodian Banks

Paragraph 4(a) provides that the portions of the Amended Guidelines relating to the selection of custodians and to the content of custody contracts also apply to the appointment of subcustodians. However, unlike Paragraph 4(b), Paragraph 4(a) does not qualify this requirement with the phrase "to the extent that it is reasonably achievable." Therefore, it appears that the Authority intends that every subcustodian bank must satisfy fully all of the selection and contract requirements applicable to custodians.

The Association believes that the blanket application to subcustodian banks of the selection and contract requirements would raise numerous practical and interpretive problems. With respect to the contract provisions, some of these problems are discussed in the next section of this letter. With respect to the selection of subcustodian banks, Paragraph 2.1(a) requires that all custodians have received at least certain prescribed ratings from Fitch IBCA, Thomson BankWatch, Moody's, or Standard and Poor's. The effect of extending this requirement to subcustodians is likely to be to preclude Funds from investing in some overseas markets and to greatly limit access to a wide range of experienced and reputable subcustodian banks in others. Therefore, the Association recommends that the Amended Guidelines be revised to eliminate the requirement that overseas subcustodians have received such ratings.

The leading subcustodian banks in many markets have not sought ratings from any of the four rating services in Paragraph 2.1(a). Ratings are a product for which these services charge a substantial fee, and banks that are active only in their local market may have had no reason to incur the cost of rating. The ability to hold assets of Singapore insurers will, in many cases, not represent a sufficiently large business opportunity to justify these banks in obtaining ratings. However, the absence of a rating is not a ground for concluding that a particular bank is not a suitable subcustodian -- indeed, an unrated bank may be a longstanding member of a particular global custodian's network and the most qualified subcustodian in its market. In the Association's view, requiring that the <u>custodian</u> be rated should be sufficient to accomplish the Authority's goals. Requiring

subcustodian ratings adds little in the way of asset safety, while severely restricting the pool of eligible subcustodians.

Requirements of Custody Contracts

As noted above, Paragraph 3.1(a) of the Amended Guidelines sets forth certain requirements for Fund custody contracts. Paragraph 4 has the effect of extending these requirements to subcustodian contracts. In some respects these requirements are modeled on U.S. SEC Rule 17f-5. However, in other respects, these provisions would require terms that are contrary to global custody practice. We recommend that the Authority amend these requirements in several important respects.[6]

A. Registration in the Name of the Insurer

Paragraph 3.1(a)(i) requires that the custody contract provide that Fund non-cash assets will be held separately from the assets of other clients of the custodian, except that, "in the case of practical or operational constraints," commingling of assets is permissible. In practice, most subcustodians maintain commingled omnibus accounts. Thus, at the subcustodian level, the assets deposited by a particular custodian for its clients are almost invariably held in a single omnibus account.

The principal reasons for omnibus accounts are lower cost and greater efficiency. However, it is not clear whether the

---

6/ We recognize that Paragraph 3.1(b) permits custody contracts to contain "in lieu of any or all of the provision specified in paragraph (a)" other provisions that the insurer determines will provide the same or greater protection. While Paragraph 3.1(b) is obviously intended to afford some flexibility concerning the content of custody and subcustody contracts, we believe that revisions to Paragraph 3.1(a) are still needed to address the points discussed in this letter concerning contractual terms.

As previously explained, we do not believe that the application of the contract requirements in Paragraph 3.1(a) to securities depositories would be feasible under any circumstances.

Authority would regard the desire to utilize omnibus accounts for reasons of efficiency as a "practical or operational constraint." We recommend that Paragraph 3.1(a)(i) be amended to delete the requirement that Fund assets not be commingled with those of other clients of the custodian. Alternatively, Paragraph 3.1(a)(i) should be amended to expressly permit omnibus accounts.[7]

B. Registration in the Name of the Custodian

The second sentence of Paragraph 3.1(a)(ii) requires that, if Fund assets are registered in the custodian's name, the custody contract must provide that the assets are being held for the benefit of the insurer. While this requirement is workable as between the custodian and the Fund, it would create significant practical problems if applied to subcustody contracts, particularly in light of the fact that omnibus accounts are routine at the subcustodian level.[8] We recommend that the second sentence of Paragraph 3.1(a)(ii) be amended to make clear that, notwithstanding Paragraph 4, this requirement does not extend to subcustody agreements.

C. Absence of Trust Law

The last sentence of Paragraph 3.1(a)(ii) requires that Fund assets be held in the name of the insurer in any jurisdiction

---

7/ The U.S. SEC has expressly permitted the use of omnibus accounts. See Custody of Investment Company Assets Outside the United States, Investment Company Act Release No. 22658 at 40-41 (May 12, 1997).

8/ In most cases, global custodians enter into a single subcustody contract with each of their subcustodians; individual subcustody contracts for each client of the global custodian are not customary. However, Paragraph 3.1(a)(ii) would apparently require that, if a subcustodian wished to employ omnibus accounts, the global custodian would be required to enter into a separate agreement with each bank in its subcustody network that holds, or may hold, assets of insurers subject to the Authority's rules. At minimum, this would be a costly and burdensome exercise. Moreover, some subcustodians may simply refuse to agree to the contractual changes necessary to comply with the Authority's rules.

"where trust law concepts do not apply." This would have the effect of prohibiting the use of omnibus accounts in all jurisdictions that do not recognize the concept of a trust. We recommend that this sentence be deleted.

As you may be aware, trusts originated in the English common law. Civil law codes, which are the foundation for the legal system in much of the world, may or may not recognize trust law concepts, depending on local legislation. Further, trusts are not an element of Islamic law. Although some non-common law legal systems recognize (or have enacted principles) that have features similar to trust law, in many cases these are applicable only to limited situations, such as personal trusts. Whether or not the law of a particular jurisdiction applies "trust law concepts" to situations involving the custody of securities could therefore frequently be a matter of debate. At a minimum, determining whether "trust law concepts" are recognized in a given country would require research and the exercise of sophisticated legal judgment.

For these reasons, the Association believes that prohibiting omnibus accounts in jurisdictions that do not apply trust law concepts would engender confusion and uncertainty and would impose severe operational restrictions on custodians. The practical effect of such a requirement could be to sharply limit the jurisdictions in which custodians were willing to hold Fund assets. Experience does not indicate that such a limitation would be offset by any material increase in asset safety.

D. Insurance or Indemnification Against Loss

Paragraph 3.1(a)(iv) requires that the custody contract must contain a provision for indemnification or insurance arrangements "such that the Fund Assets will be adequately protected to the level of reasonable care applicable in the relevant market against the risk of loss * * *." In general, most global custodians agree to accept liability (but not to indemnify) for direct losses caused by their own negligence or willful misconduct. While subcustody contracts may, in some cases, contain indemnification provisions, these may run only to the custodian, not to the custodian's clients. We assume that Paragraph 3.1(a)(iv) would be interpreted consistent with this industry practice. We recommend that the Authority make this interpretation clear. Further, the Authority should expressly

recognize that the requirements of Paragraph 3.1a(iv) need not be met by both the custody and the subcustody agreements, but rather that these requirements can be satisfied by reading together the provisions of the two agreements.

E. Access to Subcustodian Records

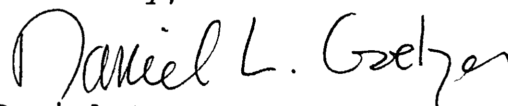
Paragraph 3.1(a)(vi) requires that the custody contract contain a provision permitting the insurer, the independent accountants appointed by the insurer, and the Authority to have access to the custodian's books and records. We recommend that this provision be amended to make clear that, notwithstanding Paragraph 4, it does not apply to subcustodians.

It is unlikely that most subcustodian banks would agree to permit the Authority to inspect their records, especially since Fund assets are not likely to be a significant portion of the assets held in custody by most subcustodians. Further, in many jurisdictions, the notion that a local bank with only domestic operations must submit to inspection by a foreign regulator may be viewed as an affront to the sovereignty of the home country. Moreover, in some countries, bank secrecy laws would limit or prohibit the ability of the insurer or its accountant to have access to subcustodian records. This is especially problematic where -- as is usually the case -- all assets held by the depository for a particular participant are commingled in a single omnibus account.

* * *

The Association appreciates the opportunity to comment on the Amended Guidelines. If you or your colleagues have questions or require further information, please contact the undersigned at Baker & McKenzie, 815 Connecticut Avenue, N.W., Washington, D.C. 20006 (telephone: 202/452-7013; fax: 202/452-7074).

Sincerely,



Daniel L. Goelzer
Counsel to the Association of Global Custodians