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CUSTODY ARRANGEMENTS

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The purpose of this paper is to highlight some of the problems encountered by the examination staff of the New York Regional Office in its review of custody arrangements of investment companies.

General

Section 17(f) of the Investment Company Act of 1940 ("the Act") and the Rules thereunder require every registered management investment company to place and maintain its securities and similar investments under the custody of:

a) A company that is a member of a national securities exchange as defined in the Securities Exchange Act of 1934 (a broker-dealer). Such arrangements are subject to the provisions of Rule 17f-1 under the Act; or

b) An investment company acting as its own custodian. Such arrangements are subject to the provisions of Rule 17f-2 under the Act; or

c) A bank or banks qualified under paragraph (1) of Section 26(a) of the Act. For the purposes of the Act, a bank is defined in Section 2(a)(5). This relationship is known as a "true custodianship."

It cannot be emphasized strongly enough that an examiner should review carefully the major operating provisions contained in custodian agreements. Such provisions include, among others, procedures relating to the receipt and delivery of investment company portfolio securities; and the execution and transmittal to the company's custodian of written authorizations by investment company personnel. Generally speaking, most, if not all, custodian agreements require that securities purchased are received by the custodian only against payment therefor, and securities sold are delivered only against the receipt of proper funds. And with respect to written authorizations, the signature of two authorized persons is required.

Rule 17f-1 Arrangements - Custody of Securities With Members of National Securities Exchanges

Rule 17f-1 under the Act requires the execution of a written contract between the investment company and the member broker-dealer firm. The contract requires that the company's securities and investments be maintained in accordance with the following:

a) That all securities and similar investments held in such custody shall, at all times, be individually segregated from the securities and investments of any other person and marked in such a manner as to clearly identify them as the property of such company.

b) That member broker-dealers shall have no power or authority to assign, hypothecate, pledge or otherwise dispose of any such securities, except pursuant to the direction of such company.

c) That such securities and investments shall be verified by actual examination at the end of each annual and semi-annual fiscal period by an independent public accountant retained by the company and shall be examined by such accountant at least one other time, chosen by him, during the fiscal year.

The staff's examinations of the investment companies with this type of custodianship disclosed that brokers sometimes failed to segregate the assets of some investment companies from those of its other clients. It was also found that the commercial paper held for these investment companies were interspersed with commercial paper belonging to other clients of the brokers. Additionally, we find, from time to time, that a portion of the equity securities of these investment companies were not physically held by the brokers and were placed by the brokers for deposit in their name at the Depository Trust Company.

Rule 17f-2 Arrangements - Custody of Investments by Registered Management Investment Company

Rule 17f-2 provides that the securities and similar investments of a registered management investment company may be maintained in the custody of such company only in accordance with the provisions of this Rule. In essence, the Rule requires:

a) That such investments be maintained by such an investment company with a bank or other company whose functions and physical facilities are supervised by federal and state authority under any arrangement whereunder the directors, officers, employees or agents of such company are authorized or permitted to withdraw such investments upon mere receipt.

b) That such investments which are deposited in the safekeeping of, or in a vault or other depository maintained by a bank, be physically segregated at all times from those of any other person and shall be withdrawn only in connection with an authorized transaction.

c) That no person shall be authorized or permitted to have access to the securities so deposited except pursuant to a resolution of the board of directors of such company.

d) That such securities and similar investments shall be verified by complete examination by an independent public accountant retained by the investment company at least three times during each fiscal year, at least two of which shall be chosen by such accountant without prior notice to such company.

The staff's recent examination of an investment company with this type of custodianship revealed that its investments were being maintained in a safe deposit box at a bank, but they were never examined and verified by an independent public accountant. After this matter was brought to the company's attention, such required examination and verification was made.

True Custodian Arrangements

The third and most common type arrangement is that between an investment company and a bank. The policy of the Division of Investment Management has been to encourage the investment company industry to adopt its "model custodian agreement." This agreement essentially calls for written instructions prepared by a designated officer or officers to be sent to such bank prior to settlement of the company's portfolio transactions as well as prior to the disbursements of any monies by the Custodian. The model agreement also explicitly calls for payment only upon delivery of portfolio securities purchased and delivery of securities sold only against receipt of payment by the bank. These

agreements further require that the names and signatures of those persons authorized by the Board of Directors to sign written instructions be filed with the custodian bank and that the custodian be notified of any changes with respect to authorized persons.

The majority of investment companies in the NYRO maintain their portfolio securities with a bank pursuant to a custody agreement conforming substantially to the model agreement. However, because of recent developments in the securities markets both custodian banks and investment companies circumvent some of the basic provisions contained in their agreements. Because these agreements require instructions to be signed by a designated officer or officers and that these instructions be presented to the bank prior to all settlements of portfolio transactions, they have caused a problem of logistics for those investment companies who trade money market instruments. These money market instruments include commercial paper, certificates of deposit, Treasury obligations, etc. Since these instruments normally settle on the same day as the trade date, around 2 p.m. each day, investment companies have found it inconvenient to get the proper authorizations signed and delivered to the Custodian bank before the transactions have settled. As a result, as our examinations have revealed, oral instructions were given to the custodian before the transaction settled and later when it was convenient, the required written instructions would follow. During examinations, the practice of not adhering to the prior written

instructions is found by reviewing the written instructions received by the custodian bank. Some instructions are dated by investment company officers subsequent to settlement date while others are date-stamped by the custodian on date of receipt. In some cases, investment company and bank officers, when questioned, inform us of their practice.

The danger of not adhering to the prior written instructions part of the custodian agreement can be illustrated by a case which we had in our region. In that case, the custodian agreement called for monies to be disbursed only upon the receipt of prior written instructions from two authorized signatories of the investment company involved. However, an officer of that investment company began to give oral instructions to the custodian to transfer money from the investment company's account to the adviser's account on which he had complete check-writing authority. By the time the practice was discovered, the officer had embezzled a considerable sum of money. He even went so far during the embezzlement of pledging certain assets of the investment company for loans to the investment company when the cash he was embezzling began to dry up. If the custodian bank and investment company had adhered to the provisions of their custody agreement in this instance, the internal control of prior written instructions signed by two officers would most likely have prevented this embezzlement.

In those cases where we have found investment companies and custodians not adhering to the prior written instructions of their agreements, we have informed them orally and by deficiency letter of the problems inherent in not providing prior written instructions and in most cases steps were soon implemented either to dex, telex or hand deliver written instructions to the bank on those items which require same day settlement.

Examinations have also uncovered many instances where custodian banks honor signatures of people who are not authorized by the board of directors to sign written instructions. Custodians also accept one signature when two are required by their custody agreements. We have also found many instances where custodians have not been notified of changes with respect to authorized signatories and have been acting on instructions from those persons even though they do not know the signature.

To some investment companies, the inconvenience of providing prior written instructions was deemed to outweigh the safeguards which they provided. Some investment companies, primarily money market funds, either amended or never adopted the requirement for written instructions of the model agreement and presently settle money market trades based on oral instructions to the custodian. However, their procedures usually require written instructions to be delivered to their custodian later that day. However, even when the agreements require that written instructions be delivered later that day, we have found instances where the custodian does not receive them for two or three days after the trade has settled.

Another irregularity found during our examination of two investment companies was the failure of the custodians to acquire physical possession of government securities against payment as required by their custody agreements, as well as the model. A physical count by the staff of the securities held in the custodian's vault for the investment company's account indicated that it did not have physical possession of numerous government securities purchased by the investment companies for periods of up to a month after the settlement date. In this instance, the custodian had its correspondent bank, a member of the Federal Reserve System, settle these transactions with Federal Funds and did not instruct its correspondent to immediately deliver the government securities to it even though the correspondent was not a sub-custodian. After this situation was brought to the attention of the management of the investment comapnies concerned, they took appropriate action to have the custodian get the securities from its correspondent; and subsequent to this, the custodian became a member of the Federal Reserve System and thus was able to settle these transactions in accordance with the terms of its custodian agreement.

However, it should be noted that, although, at this date, we have not discovered any other defalcations as a result of a bank acting on an investment company officer's oral instructions, some banks have told the staff that they do not want to accept oral instructions but if they do not go along with the wishes of their clients they may well lose them as clients.

With respect to checking accounts, Section 17(f) requires that the balances of such accounts shall at no time exceed the amount of the fidelity bond, maintained pursuant to Section 17(g) of the 1940 Act covering the officers or employees authorized to draw on such accounts. The staff has found instances where cash balances far exceed the amount of coverage of an investment company's bond maintained pursuant to Section 17(g) of the Act. In those instances, deficiency letters were sent to those investment companies involved and they responded that they would take remedial action to prevent further violations.