RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Your letter dated March 4, 1999 requests that the Division of Investment Management reconsider its position regarding the institution and annual review by an investment company’s board of directors of special procedures for the investment company’s use of repurchase agreements, and the annual review of the investment adviser’s compliance with those procedures. In addition, you request that the Division clarify that an investment company’s board of directors need not annually review the investment company’s, or its custodian’s, use of depository arrangements with certain entities in connection with the investment company’s purchase of certain certificated and uncertificated securities.

Repurchase Agreements

In a typical investment company (“fund”) repurchase agreement (a “repo”), a fund purchases securities from a bank or broker-dealer (a “counterparty”) and agrees to resell those securities to the counterparty at a stated price at a later, agreed-upon date. Upon resale, the fund receives the agreed-upon price, which includes imputed interest. The staff has taken the position that a fund repo with a broker-dealer counterparty may be considered to be the acquisition by the fund of a security issued by the broker-dealer, and may be subject to the prohibitions of Section 12(d)(3) of the Investment Company Act of 1940 (the “1940 Act”). Section 12(d)(3) of the 1940 Act provides, in relevant part, that:

it shall be unlawful for any registered investment company...to purchase or otherwise acquire any security issued by or any other interest in the business of any person who is a broker, a dealer, [or] is engaged in the business of underwriting....

1 A repo may be considered to be the acquisition of a security because it may be viewed as a secured loan provided by a fund to the counterparty and, as such, the acquisition by the fund of an evidence of indebtedness of the counterparty. For purposes of Section 12(d)(3) of the 1940 Act, the evidence of indebtedness may be viewed as a security issued by the counterparty. See American Medical Ass’n. Tax-Exempt Income Fund, Inc. (pub. avail. Apr. 23, 1978). The staff also has taken the position that fund repos with banks that are engaged in a securities-related business, including dealing in government securities, similarly may be subject to the prohibitions of Section 12(d)(3) of the 1940 Act. See Letter from Gerald Osheroff, Associate Director, Division of Investment Management, to Matthew Fink, General Counsel, Investment Company Institute, dated April 17, 1985 (pub. avail. May 7, 1985) (“May 1985 ICI Letter”).
Section 12(d)(3) was designed, in part, to prevent funds from exposing their assets to the entrepreneurial risks of an investment banking business. Based on the principle that a fund would look to the intrinsic value of the securities collateralizing the repo, rather than the financial prospects of the counterparty, the staff has agreed, under certain circumstances, not to recommend the institution of enforcement proceedings under Section 12(d)(3) against funds entering into repos with broker-dealer and bank counterparties that are engaged in a securities-related business. In particular, the staff has agreed not to recommend enforcement action when:

1. A fund's board evaluates the creditworthiness of the counterparties;
2. The repos are fully collateralized;
3. The board adopts, annually reviews, and annually reviews the investment adviser's compliance with, procedures that are designed to ensure that the repos are fully collateralized; and
4. The repo agreement contains certain provisions that are designed to ensure that the repos are fully collateralized.

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3 See Release 10666; Investment Company Act Release No. 13005 (Feb. 2, 1983) ("Release 13005"). The Division anticipated that fund directors would discharge their responsibilities for supervising repo purchases primarily by setting guidelines and standards of review for the fund's investment adviser, and monitoring the adviser's actions in engaging in repos for a fund. See Release 13005.

4 The staff has taken the position that "fully collateralized" means: (1) the market value of the securities held as collateral plus any accrued interest on those securities is equal to or greater than the amount at which the counterparty will repurchase the securities or repay the principal amount and accrued interest; and (2) the fund has actual or constructive possession of the collateral; if the collateral is not in the possession of the fund or its custodian, then it must be with a third party that qualifies as a custodian under the 1940 Act. See the May 1985 ICI Letter.

5 The staff has taken the position that the procedures should: (1) ensure to the extent practicable that the fund perfects its security interest in the securities subject to the repo; (2) provide that the custodian's records will reflect that the securities are being held in the book-entry system on behalf of the fund; and (3) provide that the custodian will furnish the fund with confirmation of the securities held on the fund's behalf. In addition, the staff has stated that the fund should include in its audit procedures a review of the practices and procedures which are followed by its custodian in connection with repo transactions. See Letter from Kathryn B. McGrath, Director, Division of Investment Management, to Matthew Fink, General Counsel, Investment Company Institute (pub. avail. June 19, 1985) ("June 1985 ICI Letter").

6 The staff has taken the position that the collateral should be marked to market daily, and that the repo agreement should provide: (1) that the counterparty will add additional collateral if the market value of the securities falls below the repo price; and (2) for the adequate segregation (footnote continued)
You acknowledge the need for funds to ensure that repos are fully collateralized and assess the creditworthiness of repo counterparties. You argue, however, that it is more appropriate for the fund’s investment adviser to perform the extensive fact-finding and detailed analysis inherent in performing repo evaluation and review. You assert that a fund’s use of repos is comparable to its other investments and, absent additional risk, there is no justification for imposing special board requirements with respect to repos. You also note that this position would be consistent with the Commission’s and the staff’s goal of reducing unnecessary burdens on fund boards in order to improve fund governance. You state that this relief would advance the staff’s stated goal that “[t]o the extent possible, operational matters that do not present a conflict between the interests of advisers and the investment companies they advise should be handled primarily or exclusively by the investment adviser.” See Division of Investment Management, U.S. Securities and Exchange Commission, Protecting Investors: A Half Century of Investment Company Regulation, 251-289, 266 (1992) (the “1992 Report”).

You note that the involvement of fund boards in evaluating the creditworthiness of repo counterparties and instituting and reviewing repo procedures was prompted by concerns that the insolvency of repo counterparties potentially could result in exposing funds that enter into repos to the risk that they would be unable to liquidate the securities held as collateral. You argue that the concerns expressed by the Commission and the staff have been reduced by certain amendments to the Bankruptcy Code, the Federal Deposit Insurance Act, the policies of the Securities Investor Protection Corporation (“SIPC”), and the Uniform Commercial Code (the “UCC”).

of the collateral and adequate records and reports showing that the collateral is being held for the fund. In addition, the staff has stated that the board should review the form of repo agreement annually. See the May 1985 ICI Letter and the June 1985 ICI Letter.

You note that the Commission amended certain rules under the 1940 Act to further this goal. See, e.g., Investment Company Act Release No. 19719 (Sept. 17, 1993) (eliminating annual board review requirement for certain procedures and arrangements under Rules 10f-3, 17a-7, 17e-1, 17f-4 and 22c-1 under the 1940 Act); Investment Company Act Release No. 19716 (Sept. 19, 1993) (eliminating the requirement that a fund’s board make certain determinations if the fund relies on Rule 12d3-1 under the 1940 Act).

For instance, you note that Congress amended Sections 546(f) and 559 of the Bankruptcy Code to provide assurances that the insolvency of a repo counterparty would not result in an automatic stay or the avoidance by the bankruptcy trustee of the buyer’s ability to liquidate the repo collateral, subject only to the possible imposition of a judicial stay obtained by SIPC in the case of a broker-dealer insolvency. You state that representatives of SIPC have indicated that SIPC would consent, and would urge the trustee to consent, to the liquidation of repo collateral upon SIPC’s receipt of certain documentation. You state that the provisions of the Federal Deposit Insurance Act that relate to repos issued by insolvent banks and thrifts were amended to provide protections that are comparable to those provided by the Bankruptcy Code.
In furtherance of the policy goals discussed in the 1992 Report, and after considering the legislative, administrative, and other developments that help to ensure that a fund would be able to promptly liquidate the securities collateralizing its repos, we agree that a fund’s investment adviser, rather than the fund’s board, may assume primary responsibility for monitoring and evaluating the fund’s use of repos. If a fund’s investment adviser assumes those responsibilities, the fund’s board would remain responsible for overseeing the fund’s use of repos to the same extent that the board oversees the other aspects of the fund’s operations. We agree, therefore, not to recommend enforcement action to the Commission under Section 12(d)(3) of the 1940 Act if a fund enters into repos with broker-dealer and bank counterparties that are engaged in a securities-related business, provided that: (1) the fund’s board or investment adviser evaluates the creditworthiness of the repo counterparties; and (2) the fund’s board or investment adviser takes steps that are reasonably designed to ensure that the fund’s repos are fully collateralized.

In addition, we believe that a fund need not adopt repo procedures, and the fund’s board need not review the form of repo agreement if, as provided for in this letter, the fund’s adviser, rather than its board, evaluates the creditworthiness of the fund’s repo counterparties, and takes steps reasonably designed to ensure that the fund’s repos are fully collateralized. If the fund’s board continues to assume those responsibilities, however, the fund should adopt repo procedures, and the board should review the procedures and the form of repo agreement initially, and any subsequent changes thereto.

You state further that Articles 8 and 9 of the UCC were amended to provide, among other things, that a repo buyer normally obtains “control” of the purchased securities if they are held in its custodial account or held by a third-party custodian subject to a control agreement, and that repo buyers that have “control” are protected from third-party claims and would have a perfected security interest position.

We note that the Commission may consider rulemaking that would codify and update certain of the Division’s positions relating to fund repos. See Regulatory Flexibility Agenda, Investment Company Act Release No. 23719 (Apr. 26, 1999) (Regulation Identifier Number 3235-AH56).
Section 17(f) of the 1940 Act prescribes certain entities that may act as the custodian of a fund’s assets. Rule 17f-4 under the 1940 Act permits a fund, or its custodian, to deposit the fund’s assets in a securities depository that is registered with the Commission as a clearing agency under Section 17A of the Securities Exchange Act of 1934 (a “registered clearing agency”) or in the Federal book-entry system for certain government securities. Paragraph (a) of the rule defines a “securities depository” as:

a system for the central handling of securities where all securities of any particular class or series of any issuer deposited within the system are treated as fungible and may be transferred or pledged by bookkeeping entry without physical delivery of the securities.

The staff previously agreed not to recommend enforcement action to the Commission under Section 17(f) of the 1940 Act if a fund, or its custodian, maintains fund assets with the following entities that are not registered clearing agencies: (1) an investment company’s transfer agent, if the fund has purchased uncertificated shares issued by the investment company; and (2) a bank, if the fund has purchased certificated securities of an issuer that are immobilized by the bank. The staff’s positions in the Letters were based, in part, on representations effectively requiring the fund to comply with the requirements of Rule 17f-4 under the 1940 Act, as then in effect, other than the requirement that the securities depository be a registered clearing agency.

At that time, Rule 17f-4 required fund boards to review annually the fund’s sub-custodial relationships with securities depositories. Subsequently, the Commission amended Rule 17f-4 to eliminate that requirement. In the adopting release, the Commission stated that requests to eliminate the annual review procedure contained in no-action letters and exemptive orders relating to Rule 17f-4 would be reviewed on a case-by-case basis.

You request that we clarify that a fund relying on the Letters need not have its board annually review the fund’s depository arrangements with an investment company’s transfer agent or a bank. You assert that the fact that investment company transfer agents and banks are not registered clearing agencies does not necessitate the board’s annual review of the depository arrangements between these entities and the fund. You assert that the fund’s use of these

10 See American Pension Investors Trust (pub. avail. Feb. 1, 1991) (“APIT”); Fundvest (pub. avail. Nov. 21, 1984) (“Fundvest”) (the staff agreed not to recommend enforcement action under Section 17(f) of the 1940 Act if funds investing in uncertificated shares of other funds maintain custody of the shares with the transfer agents of those funds). See also Salomon Brothers Inc (pub. avail. Apr. 8, 1985); Morgan Guaranty Trust Co. of N.Y. (pub. avail. Aug. 14, 1985) (the staff agreed not to recommend enforcement action under Section 17(f) of the 1940 Act with respect to the use of a bank as custodian for certain fund assets (variable rate demand notes) maintained in a book-entry system) (collectively with APIT and Fundvest, the “Letters”).

depository arrangements has become commonplace, generally does not involve conflicts of interest, and involves a degree of technical expertise that is exercised more appropriately by fund management. You assert that fund shareholders are sufficiently protected if the board approves each arrangement initially and any subsequent changes thereto. We agree that a fund, or its custodian, may maintain fund assets with an investment company’s transfer agent or a bank, in the manner described in the Letters, without obtaining annual board review of the depository arrangements, provided that the board has approved each arrangement initially, and approves any subsequent changes thereto.

Alison M. Fuller
Assistant Chief Counsel
March 4, 1999

Douglas J. Scheidt, Esq.
Chief Counsel
Division of Investment Management
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Re: Modification of Boards of Directors' Responsibilities Regarding Repurchase Agreements

Dear Mr. Scheidt:

The Investment Company Institute ("Institute") is submitting this letter to request the staff of the Division of Investment Management to reconsider its position that investment company boards of directors have special monitoring responsibilities in connection with a fund’s use of repurchase agreements (commonly referred to as “repos”). Specifically, the Institute requests that the staff eliminate its stated requirement that mutual fund boards institute, and perform annual reviews of the adviser’s compliance with, special procedures for repo transactions. We believe that repo transactions warrant no more intensive board attention than do a fund’s ordinary investments.

The Institute believes that requiring boards to institute and annually review compliance with repo procedures and forms inevitably and inappropriately leads directors either to “micro-manage” operational matters or else to engage in a merely ritualistic function. This level of involvement is an ineffective use of the board’s time and limited resources. Rather, as the staff has recognized, it is the fund’s adviser who is more appropriate and better positioned to perform the extensive fact-finding and detailed analysis inherent in performing repo evaluation.

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,446 open-end investment companies ("mutual funds"), 456 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $5.662 trillion, accounting for approximately 95% of total industry assets, and have over 62 million individual shareholders.

2 These requirements arose out of two interpretive releases [Investment Company Act Release No. IC-13005 (February 2, 1983) ("Release 13005") and Investment Company Act Release No. IC-10666 (April 18, 1979) ("Release 10666")] and a staff letter to the Institute interpreting those releases [Letter from Kathryn B. McGrath, Director, Division of Investment Management, SEC, to Matthew Fink, General Counsel, Investment Company Institute (June 19, 1985) (the "1985 Letter"). In Release 13005, the staff acknowledged that boards may properly delegate responsibilities for carrying out repo procedures, including making creditworthiness determinations, to a fund’s investment adviser. The substance of the 1985 Letter was to clarify that, in addition to guidelines for determining that repo counterparties are creditworthy, repo procedures should also provide for fund custodians to effectively have possession of the repo collateral. The 1985 Letter also added, however, that fund boards "should monitor compliance with those procedures and reevaluate the procedures, including the form of repo agreement, at least annually."
and review. Clearly, fund shareholders would be better served if directors were relieved of this responsibility and therefore able to devote greater time and attention to matters that are of a more appropriate nature for board consideration.

Repo transactions generally are viewed as among the safest of investments, as reflected by the extraordinary depth of the repo market, and certainly do not present any greater risk to the fund than many other fund investments. Yet, the staff does not require fund boards to institute special procedures or engage in specific, annual compliance reviews in connection with a fund's investments in other portfolio securities. Absent material additional risk, there is no justification for imposing these requirements with respect to repos.

As noted above, the staff's requirements were developed primarily through staff interpretive releases and a letter to the Institute. In Release 10666, the staff granted relief under Section 12(d)(3) of the Investment Company Act of 1940 ("Investment Company Act"), permitting investment companies to acquire securities issued by a broker or dealer, on the condition that the value of the securities collateral remain, at all relevant times, "at least equal to the amount of the loan, including related accrued interest earned thereon." In Release 13005, the staff added a creditworthiness evaluation requirement because of concerns that the effect of insolvencies involving certain repo issuers potentially could result in exposing entities purchasing repos to the risk that they would be unable to liquidate the collateral securities upon the insolvency of a defaulting party. The evaluation requirement was imposed to minimize the possibility of this occurrence.

The need for funds to fully collateralize repos, as contemplated by Release 10666 (or in the case of money market funds seeking look-through treatment to the underlying collateral, as contemplated by Rule 2a-7 under the Investment Company Act), and the need for funds to assess the creditworthiness of their counterparties, are well established. The Institute does not disagree with the appropriateness of these standards; however, boards do not need to institute special procedures or conduct formalistic annual reviews in order to be confident that these standards will be applied.

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3 This is particularly true of reviews of the forms of repo agreement, which are lengthy and legalistic documents. The repo agreements that funds generally enter into typically involve a number of different counterparties, each of which may use its own form. Consequently, the materials provided to a fund's directors containing the forms of repos that the fund may use are voluminous and complex. Requiring fund directors to review these forms therefore is an unrealistic and inappropriate burden.

4 The average daily volume in the repo market is over $940 billion and total outstanding repos and reverse repos during the week ended September 17, 1997 was placed at $2.1 trillion. 83 Fed. Res. Bull. A29 (Dec. 1997).

5 See Release 10666. The staff's position was based on the premise that an investment company, in determining whether to enter into a repurchase agreement transaction with a particular broker/dealer, "would look to the intrinsic value of the collateral rather than the creditworthiness or other risks associated solely with the business operations of the broker/dealer." The Release also stated that fund directors should review the fund's (1) accounting methods for repurchase agreements and related disclosures, (2) loan policies articulated in the fund's registration statements, and (3) securities trading practices generally.

6 See Release 13005.
Moreover, since 1983 the basis for the staff's concern has been reduced. Amendments to the Bankruptcy Code and the rules governing Federal Deposit Insurance Corporation ("FDIC") receiverships and the policies established by the Securities Investor Protection Corporation ("SIPC") all have provided greater assurance that a fund that is a repo buyer will be able to close out its position in timely fashion in the event of a counterparty's insolvency.7 In addition, amendments have been made to the Uniform Commercial Code ("UCC") to better enable funds to protect their repo positions from third party claims and assure that they can obtain perfected positions in repo collateral.8

The Institute's request would advance the Commission's and the staff's goal of reducing unnecessary burdens on fund directors in order to improve investment company governance. In the past several years, changes along these lines have been made to several rules under the Investment Company Act.9 These changes were made pursuant to recommendations in the staff's 1992 report, entitled "Protecting Investors: A Half Century of Investment Company

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7 Sections 546(f) and 559 of the Bankruptcy Code were amended in 1984 to provide assurance that the insolvency of a seller under a "repurchase agreement" (as defined in the Code) will not result in an automatic stay or the avoidance of the buyer's ability to liquidate repo collateral, subject only to the possible imposition of a judicial stay obtained by SIPC in the case of a broker-dealer insolvency. See, e.g., In re Bevill, Bresler & Schulman Asset Management Corp. v. Spencer Savings and Loan Assn, 878 F.2d 742 (3rd Cir. 1989). Comparable protections were obtained with respect to insolencies of FDIC-insured financial institutions under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA") (establishing special exceptions to FDIC's avoidance powers for "qualified financial contracts" under §11(e)(8) of the Federal Deposit Insurance Act, 12 USC 1821(e)(8)).

Also, through a series of letters, SIPC has stated its intention to modify the standard form of stay order it proposes to the court in broker/dealer liquidation proceedings under the Securities Investor Protection Act of 1970 ("SIPA"). See Letter from Michael E. Don, President, SIPC, to Seth Grosshandler, Cleary, Gottlieb, Steen & Hamilton (Feb. 14, 1996), and Letter from Michael E. Don, Deputy General Counsel, Office of General Counsel, SIPC, to Eugene Marans, Cleary, Gottlieb, Steen & Hamilton (August 29, 1988) (collectively, the "SIPC Letters"). Among other things, the SIPC Letters stated that in the context of SIPA proceedings, although the exercise of close-out rights under any type of repo transaction is subject to the procurement by the SIPC of an order staying creditor actions, it would consent (and urge the trustee to consent) to the liquidation on the receipt of certain documentation, including an affidavit from the repo buyer that it has a perfected security interest in the securities collateral. The SIPC Letters further added that any such close-outs would occur within days after the initiation of a liquidation proceeding -- or sooner in periods of particular market volatility. Id.

8 Specifically, Articles 8 and 9 of the UCC were amended, among other things, to provide that a repo buyer normally obtains "control" of the purchased securities if they are held in its custodial account or held by a third party, custodian subject to a control agreement, and that repo buyers that have "control" are protected from third-party claims and would have a perfected security interest position.

9 For example, Rule 12d3-1 was revised to eliminate the requirement that directors determine the credit quality of debt securities of issuers that derived more than 15% of their gross revenues from securities related activities during their most recent fiscal year. Investment Company Act Release No. 19716 (Sept. 16, 1993). In addition, the annual board review requirement was eliminated with respect to procedures and agreements involving certain affiliated transactions (Rules 10f-3, 17a-7, and 17e-1), net asset value pricing time determinations (Rule 22c-1), and securities depository arrangements (Rule 17f-4). See Investment Company Act Release No. 19719 (Sept. 17, 1993) ("Release 19719"). Moreover, more recently, Rule 17f-5 was amended permitting fund directors to delegate to fund advisers detailed findings related to foreign custody arrangements. Investment Company Act Release No. 22658 (May 12, 1997).
Regulation," in which the staff, after conducting a comprehensive review of investment company regulations, recommended, among other things, the elimination of many of the formalistic requirements that unnecessarily burden fund directors.\footnote{See SEC, Division of Investment Management, Protecting Investors: A Half Century of Investment Company Regulation, Corporate Governance, pps. 251-289 (May 1992). In its review, the staff recommended that "to the extent possible, operational matters that do not present a conflict between the interests of advisers and the investment companies they advise should be handled primarily or exclusively by the investment adviser." Id. at 266 (emphasis added). The staff further recommended that, "in order to allow directors to devote their time and attention to truly important matters . . . provisions that require directors to conduct reviews and make detailed findings that involve more actual than substance should be eliminated." Id.}

For the reasons discussed above, we respectfully submit that boards only be expected to exercise normal oversight responsibilities with respect to repo transactions (i.e., similar to those exercised with respect to other ordinary portfolio transactions), and not be required to institute special procedures or engage in a formal, annual review.

In a related matter, the Institute notes that several no-action letters issued under Rule 17f-4 under the Investment Company Act impose an annual board review requirement in connection with a fund’s custodial arrangements. Under those arrangements, and consistent with Section 17(f) of the Investment Company Act, certain entities -- particularly, transfer agents and banks -- were allowed to serve as the "substantive equivalent" to securities depositories.\footnote{See, e.g., American Pension Investors Trust (pub. avail. Feb. 1, 1991) and Fundvest (pub. avail. Nov. 21, 1984) (permitting, in funds of funds arrangements, the underlying funds' transfer agents to custody fund shares in a book-entry system, subject to the provisions of Rule 17f-4); and Morgan Guaranty Trust Co. of New York (pub. avail. Aug. 14, 1985) and Salomon Brothers Inc. (pub. avail. April 8, 1985) (permitting banks to custody fund assets -- in both instances, variable rate demand notes -- in a book-entry system, subject to the provisions of Rule 17f-4).} The relief provided in those letters was conditioned on each fund’s adherence to itemized procedures that mirrored the requirements of Rule 17f-4, including paragraphs (c) and (d) -- the annual board review requirement. For the same reasons that the Commission amended Rule 17f-4 to eliminate this requirement -- i.e., that it had become "largely perfunctory"\footnote{See Release 19719 at n.13. The Commission also noted that once established, the depository arrangements are unlikely to change from year to year.} -- we believe such reasons apply equally here. Clearly, the fact that investment company transfer agents and banks are not registered clearing agencies does not necessitate the board’s annual review of the depository arrangement between these entities and the funds. Moreover, since the time of those letters, funds’ use of these depository arrangements has become commonplace, generally does not involve conflicts of interest, and involves a degree of technical expertise that is exercised more appropriately by fund management. We believe that fund shareholders are sufficiently protected if the board approves each arrangement initially and any subsequent changes thereto. Accordingly, we request clarification that the board review condition stated in those letters is no longer required.
The Institute appreciates the staff's consideration of this matter. If you have any questions or would like to discuss any issues relating to the above recommendation, please do not hesitate to contact the undersigned at (202) 326-5824 or Barry Simmons at (202) 326-5923.

Sincerely,

Amy B.R. Lancellotta
Senior Counsel

cc: Paul F. Roye
Director
Division of Investment Management