MEMO# 11083

June 29, 1999

SEC STAFF MODIFIES ITS POSITION ON DIRECTORS' RESPONSIBILITIES REGARDING REPURCHASE AGREEMENTS AND DEPOSITORY SECURITIES ARRANGEMENTS

1 Letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, to Douglas J. Scheidt, Chief Counsel, Division of Investment Management, Securities and Exchange Commission, dated March 4, 1999. 2Letter to Investment Company Institute from Alison M. Fuller, Assistant Chief Counsel, Division of Investment Management, SEC, dated June 15, 1999. 3 The staff's position regarding funds that engage in repo transactions involving a broker-dealer counterparty is that it may be considered to be the acquisition by the fund of a security issued by the broker-dealer, and thus, may be subject to the prohibitions of Section 12(d)(3) of the Investment Company Act. The staff had agreed, however, not to recommend enforcement action when certain conditions were met, including, among others, that a fund's board evaluates the creditworthiness of the counterparties, and 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. 1 [11083] June 29, 1999 TO: DIRECTOR SERVICES COMMITTEE No. 18-99 SEC RULES MEMBERS No. 43-99 RE: SEC STAFF MODIFIES ITS POSITION ON DIRECTORS' RESPONSIBILITIES REGARDING REPURCHASE AGREEMENTS AND DEPOSITORY SECURITIES ARRANGEMENTS ____ The staff of the SEC's Division of Investment Management, in response to a request by the Institute,1 has issued a no-action letter under Section 12(d)(3) of the Investment Company Act of 1940 modifying its position on fund directors' responsibilities regarding repurchase agreement ("repo") transactions.2 The staff's letter also provides interpretive guidance with respect to certain securities depository arrangements. The letters are attached and summarized below. Repurchase Agreements The Institute requested the staff to reconsider its position regarding the institution and annual review by fund directors of special procedures for fund use of repurchase agreements and the annual review of the investment adviser's compliance with those procedures.3 The Institute's letter explained that it is more appropriate for fund advisers to perform the extensive fact-finding and detailed analysis inherent in performing repo evaluation and review. The letter also noted that this position is consistent with the Commission's and the staff's goal of reducing unnecessary burdens on fund boards in order to improve fund governance, and would advance their goal that operational matters that do not present a conflict of interests between advisers and the

funds they advise should be handled primarily or exclusively by the adviser. 2In response, the staff has agreed not to recommend enforcement action to the Commission under Section 12(d)(3) of the Investment Company 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 permitting a fund's adviser to assume primary responsibility for monitoring and evaluating the fund's use of repos, the staff noted that the fund's board would still 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. In addition, the staff's letter states that a fund need not adopt procedures, and its board need not review the form of repo agreement, if the adviser, rather than the 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. The staff's letter concludes that if a 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. Securities Depository Arrangements The Institute also requested similar clarification of directors' responsibilities for securities depository arrangements under Rule 17f-4 of the Investment Company Act. That rule permits a fund or its custodian to deposit fund 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. In the past, the staff has provided no-action relief under Section 17(f) of the Investment Company Act to permit a fund or its custodian to maintain fund assets with certain entities that are not registered clearing agencies (e.g., a transfer agent or a bank) on the condition that it comply with the requirements of Rule 17f-4, which, among other things, required fund boards to annually review the fund's sub-custodial relationships with securities depositories. The Institute's letter pointed out that since Rule 17f-4 was amended to eliminate the annual board review requirement, adherence of that requirement by parties relying on those letters similarly should no longer be a condition. The fact that fund transfer agents and banks are not registered clearing agencies does not necessitate annual board review of the depository arrangements between those entities and the fund. The letter also explained that fund use of such arrangements has become commonplace, generally does not involve conflicts of interest, and involves a degree of technical expertise that is exercised more appropriately by the fund's adviser. In providing interpretive relief, the staff stated that a fund, or its custodian, consistent with the no-action letters, may maintain fund assets with a fund's transfer agent or a bank, without obtaining annual board review of the depository arrangements, provided the board has approved each arrangement initially, and approves any subsequent changes made thereafter. Barry E. Simmons Assistant Counsel 3Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment referred to in this Memo, please call the ICI Library at (202) 326-8304, and ask for attachment number 11083. ICI Members may retrieve this Memo and its attachment from ICINet (http://members.ici.org).