

MEMO# 3120

September 24, 1991

SAFETY OF CASH HELD BY CUSTODIAN BANKS

-1- September 24, 1991 TO: BOARD OF GOVERNORS NO. 73-91 MEMBERS - ONE PER
COMPLEX NO. 42-91 OPERATIONS COMMITTEE NO. 29-91 SEC RULES COMMITTEE NO. 58-91
RE: SAFETY OF CASH HELD BY CUSTODIAN BANKS

The Institute has been examining the extent to which uninvested cash held by investment companies in their custodian banks may be at risk in the event of the custodian bank's failure. The Institute has obtained from its counsel, Kirkpatrick & Lockhart, a memorandum discussing: (i) the extent to which the failure of a custodian bank could result in the loss of cash assets; (ii) several options that may permit an investment company to better protect cash held in custodial accounts; and (iii) whether the Investment Company Act imposes a duty on the directors of investment companies to take special steps with regard to the safety of custodial cash. While the focus of the review concentrated on cash in custodial accounts relative to portfolio activity, members should be aware that the status of cash relative to transfer agent activities may be subject to the same possible risks. A copy of counsel's memorandum is attached for your information. The memorandum notes that each investment company is generally entitled to a maximum of \$100,000 in FDIC insurance in a given custodian bank and that there is no "pass-through" of deposit insurance to investment company shareholders. Furthermore, custodial cash generally is not entitled to any secured or preferential status in bank insolvency proceedings. Consequently, an investment company that maintains large cash deposits with its custodian bank may be exposed to a significant risk of loss in the event of the bank's failure. Counsel's memorandum discusses several arrangements that may improve the safety of custodial cash. The staff of the Institute also has met with a number of major custodian banks to discuss this issue and to suggest that they develop mechanisms -2- that offer better protections for cash held in a custodial capacity, including the creation of a "narrow" or "core" bank facility devoted primarily to servicing and protecting cash in mutual fund custodial accounts. Nevertheless, it appears that there is no particular arrangement that can absolutely guarantee the safety of cash held in a custodian bank. Moreover, there may be significant costs and practical impediments associated with devices designed to reduce or better protect cash on deposit with custodian banks. The safety of cash held in custodian banks is likely to continue to be a significant issue given the absence of special protected status for such cash, the current problems of the banking system, and the proposals under consideration by Congress for limitations on government assistance to uninsured bank depositors. Consequently, members may wish to review the safety considerations relevant to their custodial relationships. Counsel's memorandum notes that the Investment Company Act does not impose any specific requirements for assessing the safety of cash deposits at custodian banks provided the banks meet the \$500,000 capitalization requirement of Section 17(f). However, under the Act and

applicable state law, the directors of an investment company are charged with a general fiduciary duty to safeguard the assets of the fund. In fulfilling this duty, investment company directors might be expected to evaluate a number of relevant factors, including the financial health of the fund's custodian and transfer agent bank or banks, the extent to which the fund regularly maintains cash deposits in excess of FDIC insurance, any existing or available arrangements to further safeguard cash assets and the cost and practicality of such arrangements. In considering these issues, it may be appropriate to consult directly with the banks concerned and to institute a system to monitor on an ongoing basis the financial condition of bank custodians and banks holding cash in transfer agent accounts. In some cases, contingency planning may be prudent regarding steps to be taken should a bank's condition materially deteriorate. To date, the Institute is aware of no actual losses associated with the failure of banks holding cash of a fund or its transfer agent. However, given public concerns over the difficulties of financial institutions generally, members may wish to carefully consider the matters discussed in the attached memorandum and their applicability to their own custodial and transfer agent relationships. In so doing, members may wish to review and balance costs with risks in structuring and monitoring these relationships. -3- The Institute will continue to discuss this issue with custodian banks. We will keep you advised of developments and welcome any comments or suggestions regarding this issue. Lawrence A. Rogers Donald E. O'Connor Senior Counsel Vice President-Operations Attachment