MEMO# 33866

October 27, 2021

ICI Files Complaint for Declaratory Relief in California Superior Court to Prevent Premature Escheatment of Fund Accounts

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TO: Operations Committee
SEC Rules Committee
Transfer Agent Advisory Committee RE: ICI Files Complaint for Declaratory Relief in California Superior Court to Prevent Premature Escheatment of Fund Accounts

The Institute has filed a Complaint for Declaratory Relief in the Superior Court for the County of Sacramento to address members' concerns with the interpretation of the State's Unclaimed Property Law by the California State Controller's Office.[1] The basis for the suit, which will impact all mutual funds with shareholders residing in California, is briefly described below.

Like all states' laws, California's Unclaimed Property Law requires the escheatment of financial accounts, including mutual fund accounts, when the owner of the account is deemed to have abandoned the account.[2] In California, a mutual fund account is to be deemed abandoned when two conditions are met:

1. The owner has not taken any action to indicate an interest in the account for more than three years; AND
2. The holder of the account (i.e., the mutual fund) does "not know the location of the owner at the end of this three-year period."[3]

Under long-standing industry practice and consistent with SEC Rule 17Ad-17,[4] mutual funds and their transfer agents presume that they "know the location of the owner" if mail that is sent to the owner via the U.S. Postal Service at the owner's last known address is not returned to the mutual fund as "undeliverable." Of concern to the Institute and its members is the fact that the Controller's office construes condition (2) above to require the mutual fund to send a piece of mail to the owner that requires the owner to affirmatively contact the mutual fund to confirm the owner's current address. Not surprisingly, the Controller's interpretation of this statutory provision is calculated to result in the escheatment of mutual fund accounts that have not been abandoned. Such escheatment has significant consequences for the owners of these account because California law requires all such escheated accounts to be liquidated shortly after escheatment, thereby denying the owner all future growth and reinvestment of dividends in these accounts.

In addition to the adverse consequences the Controller's interpretation has on shareholders, it also has serious consequences for mutual funds. This is because, if the mutual fund escheats the account based on the Controller's interpretation, which is not consistent with a plain English reading of the statute, and a court determines the Controller's interpretation to be erroneous, the mutual funds that escheated accounts in reliance on the Controller's interpretation maybe liable to the owners of the escheated accounts and required to make them whole.[5] On the other hand, if the mutual funds do not escheat these accounts based on the Controller's interpretation, the fund may be sanctioned by the Controller's Office for non-compliance with the law.

In order to resolve members' concerns with the Controller's interpretation of the law and resolve, once and for all, members' compliance responsibilities, the Institute's Complaint seeks a judicial determination that "if mail sent to the address of record of the owner of the securities is not returned by the U.S. Post Office as undeliverable, then the holder [e.g., mutual fund] is presumed to know the location of the owner and therefore the conditions for escheatment of the securities have not been satisfied."

The states' unclaimed property laws and their adverse impact on mutual fund investors have long been of concern to the Institute. In addition to lobbying for investor-friendly changes to the states' laws and encouraging reporters to right stories to alert investors to these laws, the Institute has also created a Resource Center to educate investors about these laws and steps they can take to protect their accounts from being deemed abandoned. The Resource Center is available at: https://www.ici.org/lost_property.

We will keep members apprised of the progress of the Institute's lawsuit. If you have any questions concerning this suit or the states' unclaimed property laws, please do not hesitate to contact the undersigned at tamara@ici.org.

Tamara K. Salmon
Associate General Counsel

endnotes

[1] See The Investment Company Institute v. Betty T. Yee in her capacity as the Controller of the State of California: the California State Controller's Office (the "Compliant"). A copy of the Complaint is attached.

[2] The rationale behind such laws is that if the holder of the account (the mutual fund) no longer has a valid address on the owner, if the account is turned over to a state, the state can use its "superior resources" (e.g., tax, property, and voting records) to locate the owner and reunite the owner with their property. In reality, the states do not use their resources to find the owners. Instead, generally speaking, shortly after the property escheats, the states liquidate these accounts and use the proceeds as a source of revenue. In California, escheated property is the fifth largest source of revenue for the State. The four larger

sources of revenue are derived from taxes.

[3] See Section 1516 of the California Unclaimed Property Law.

[4] SEC Rule 17Ad-17, which applies to transfer agents and broker-dealers, requires such firms to conduct searches using nationwide databases (as defined in the rule) to find a valid address for an owner if a piece of mail sent by the firm to the owner is returned to the firm as undeliverable. In the event a valid address cannot be found, the firm is required to report to the Commission on an annual basis the number of its "lost securityholders." There is no escheatment under Federal law. Instead, the accounts of lost security holders are escheated under the laws of the state and, generally speaking, the account will escheat to the state where the account owner last resided.

[5] The states' unclaimed property laws, including California's, provide immunity from liability to mutual funds that escheat property in accordance with the state's law. If funds escheat accounts when state law does not require such escheatment, the mutual fund loses such immunity.
