The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

May 3, 2002

Letter Regarding Recommendations for European Settlement, Clearance System, May 2002

May 3, 2002

Elias Kazarian
European Central Bank

Christoph Crüwell
Committee of European Securities Regulators

Dear Mr. Kazarian and Mr. Crüwell:

The Investment Company Institute, the national association of the US investment company industry, appreciates the opportunity to comment to the Committee of European Securities Regulators and the European System of Central Banks (the Group) in connection with the Group's project to develop standards and recommendations for securities settlement systems and central counter-parties at the European level.[1]

Our letter is intended to provide the views on these matters of the investment fund industry, an industry that increasingly is involved in making portfolio investments across borders. The letter explains the reasons why securities clearance and settlement issues are particularly important to the industry and describes the elements of a sound securities clearance and settlement system, from the perspective of investment funds. Because investment funds also are issuers of securities, the letter recommends that systems for the clearance and settlement of their capital shares be allowed to develop separately to accommodate the industry's unique characteristics.

The Importance of Clearance and Settlement Issues to Investment Funds

Because open-end investment funds issue redeemable securities, they are required to value their portfolio securities daily and to maintain liquid portfolios in order to be able to meet redemptions. They also are subject to strict regulations with respect to custody of their assets. Problems in clearance and settlement systems can make it difficult for investment funds to comply with these requirements in addition to exposing them to significant risks. Examples of these problems include lengthy delays in settlement, the lack

of a reliable trade matching process, share transfers being subject to frequent objections or relatively high trade fail rates, and the lack of effective procedures for unwinding transactions. Each of the foregoing can make it very difficult for investment funds to determine precisely what securities they own and what their value is. In addition, an investment fund cannot regard a security as liquid if it cannot be resold until it is reregistered. Clearance and settlement systems also can expose funds to risk if they require a fund custodian to deliver securities before receiving payment, or to pay for securities before receiving the securities.

Elements of a Sound Securities Clearance and Settlement System

In 1997 the Institute, on behalf of investment fund industry associations in Europe, North America, South America and the Asia Pacific region, published a report that set out seven recommended elements for a sound clearance and settlement system, from the perspective of the investment funds industry.2 The Institute recommends that any European level standards for clearance and settlement that are developed include the seven elements identified in that report, which are described below:

1. Trade Matching

It is critical that the process of matching trades include all parties to the transaction, i.e. the local custodian, the global custodian, and the investment fund, as well as local brokers. An automated, real-time matching process is ideal.

2. Central Depository

Book entry systems present far fewer risks than systems involving physical certificates. A centralized depository should be authorized to handle all or nearly all of the securities traded in the applicable market, to act as registrar for all issues eligible for deposit, to automatically transfer shares, and to simultaneously handle and link both the securities and cash sides of the transaction. It is important that the system also recognize the distinction between record and beneficial owner and permit the depository to hold securities in trust, as bare trustee, in omnibus accounts in nominee name. The depository should be subject to regulation and inspection to ensure that appropriate controls are implemented.

3. Settlement Process

Settlement systems should seek to eliminate investor exposure to the credit risks of parties involved in the transaction. The preferred practice is a settlement system in which good title to securities and good funds are exchanged simultaneously and irreversibly, with settlement effectuated no more than three days following every trade.

4. Fail Procedures

Investment funds need certainty about the outcome of a transaction. Fail procedures should be clear, provide an expeditious closure to the transaction, and be consistently enforced by an independent regulatory body such as a stock exchange or securities commission.

5. Information/Messaging Process

Standardized, automated information and message systems reduce the likelihood of error in implementing an investor’s instructions and the time required to detect such an error. Internationally recognized information/messaging systems, such as SWIFT, are thus

preferred.

6. Regulatory Framework

Securities markets should have a well-established securities regulator with broad enforcement powers and a well-developed system of regulations that are consistently interpreted and enforced. Foreign investors should not be treated differently than domestic investors.

7. Legal Framework

A reliable securities system requires a well-defined system of property, contract, securities, trust, bankruptcy and tax laws that permits relatively speedy access to both courts and arbitration systems, produces final judgments, and provides a relatively convenient mechanism to enforce them.

Investment Fund Capital Shares

It is unclear from the Call for Contributions issued by the Group whether the definition of securities covered by the project would include the shares or interests that an investment fund issues to its unit holders. Investment funds typically offer their shares to the public continuously, often through a number of different distribution channels, and also generally allow investors to exchange from one fund in the fund family to another. We believe that development of an efficient clearance and settlement system for investment fund capital shares in Europe will involve unique elements that may be better addressed separately, rather than through the Group's current project. There are a number of efforts underway in Europe at this time to develop specialized systems for clearing and settling investment fund shares. We hope that the Group's work will not in any way hinder the development of these specialized investment fund systems.

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We appreciate the opportunity to provide these general comments on the Group's work. If you have any questions about our comments, please contact me at 202 326-5826 or at podesta@ici.org.

Very truly yours,

Mary S. Podesta
Senior Counsel

ENDNOTES

1 The Institute's membership includes 9,064 open-end investment companies (mutual funds), 485 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.067 trillion, accounting for approximately 95 percent of total industry assets, and over 88.6 million individual shareholders.

2 "Emerging Market Clearance and Settlement Issues for Investment Funds" (Investment Company Institute 1997.) Participants at an annual international conference of investment fund industry representatives agreed to prepare the report which detailed preferred clearance and settlement practices and described the extent to which the systems in 21 emerging market countries met those standards.