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Custody and Insurance

An elemental protection for mutual fund investors is the safekeeping of a fund's assets. A mutual fund must meet strict standards for the custody of its investments. A fund must also maintain fidelity bond insurance against embezzlement losses.

The independent directors need to monitor the fund's adherence to sound safekeeping and insurance standards.

Who Can Be A Custodian?

The 1940 Act offers a mutual fund three options in providing custody for its investments: (1) a bank, (2) a broker-dealer, or (3) self-custody by the fund itself.

Banks. Bank custody is the easiest and most popular option for mutual funds. When a mutual fund uses an unaffiliated bank for custody services, there is no specific 1940 Act requirement for board approval of the selection or of the custody agreement. Most funds, however, do get board approval in view of the importance of custody to a fund's operations.

In considering a bank custodian, you should take into account such factors as cost, quality of service, the bank's experience with mutual fund custody, its reputation, its technology level, its size, and the extent of the bank's global reach.

Broker-Dealers. SEC rules impose rigorous requirements, including physical segregation and marking of fund assets, on a broker-dealer acting as custodian for a mutual fund. These make broker-dealer custody impractical for both the broker-dealer and the fund. Very few mutual funds use the broker-dealer option.

Self-Custody. A mutual fund may undertake custody of its securities and investments itself, but only in accordance with strict and detailed guidelines. Since there can be cost advantages to self-custody, some funds do in fact handle their custody needs that way.

If the fund's custodian is a bank affiliated with the management, the fund must follow the self-custody rules.

If any of your funds are handling custody themselves or using an affiliated bank as custodian, you need to stay alert to a few key features of the self-custody rules.

SELF-CUSTODY

Board of Directors Action:

- ▲ The board must authorize no more than five specific fund officers and management employees to have access to the fund's securities.
- ▲ The board must designate a fund officer or director (not one of the five authorized for access) to receive detailed records of deposits and withdrawals.

Other Features:

- ▲ The fund must *deposit* its securities in a bank or other depository (which may be a management affiliate).
 - ▲ The bank or depository must *physically segregate* the fund's securities.
 - ▲ *Each instance* of fund access to the securities is to be only by two or more (one a fund officer) of the fund's authorized five, accompanying each other.
 - ▲ A *detailed record* of each deposit or withdrawal is to be sent promptly to the single fund officer or director designated by the board.
 - ▲ The fund's independent public accountant must make three *examinations* of the self-custody arrangements each fiscal year, two to be surprise exams.
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The independent directors, as well as the board as a whole, must be satisfied that the self-custody arrangements are in the best interests of the fund's shareholders. You should consider the relative security, cost, and service of the proposed self-custody arrangements.

Other Safekeeping Guidelines

Other federal guidelines enable funds to use securities depositories, to keep securities abroad, to trade in commodities markets, and to maintain cash accounts.

Securities Depositories. The great bulk of securities traded in the U.S. today are held in and transferred through securities depositories. These treat all deposited securities of the same kind as fungible and settle transfers between participants by book entry without physical delivery. Participation in these clearing systems, directly or through a custodian, is a given of running a mutual fund or being in any aspect of the securities business.

Federal rules authorize mutual funds to participate in any securities depository (such as Depository Trust Company) registered with the SEC and in the Federal Reserve/U.S. Treasury book-entry system for U.S. Government obligations. The fund's board must approve the depository arrangements and adopt measures to guard against loss from unauthorized instructions.

Securities Lending. Mutual funds may lend securities from their custody accounts in order to participate in the active securities lending market.

SEC rules require that the fund or its custodian adhere to standard market practices, such as full cash or equivalent collateral, daily mark to market, and the right to terminate.

Offshore Custody. The SEC allows mutual funds to keep securities and cash abroad under certain conditions.

OFFSHORE CUSTODY

Board of Directors Action:

- ▲ The board may delegate responsibility for offshore custody arrangements to:

- An officer of the fund.
 - The investment adviser.
 - A U.S. or foreign bank.
- ▲ In delegating, the board must:
- Find it reasonable to rely on the delegate.
 - Get written reports from the delegate.
 - Have the delegate agree to exercise reasonable care.

Other Features:

- ▲ A fund may use offshore custody arrangements for:
 - Investments whose primary market is outside the U.S.
 - Cash and equivalents needed to settle offshore transactions
 - ▲ The offshore custodian must be either a U.S. bank offshore branch or subsidiary, a foreign bank, or a foreign securities depository or clearing agency.
 - ▲ The delegate must find that the offshore custodian will provide reasonable care for the fund's assets.
 - ▲ The fund must get a written custody agreement with specified protections from the offshore custodian.
 - ▲ The fund must have a system for monitoring offshore custody arrangements.
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The board should review at least annually the fund's offshore custody arrangements and the performance of its delegate.

Futures and Options Margin. Some mutual funds make investments in futures and options contracts, mostly involving financial derivatives and foreign currencies. These involve trades in commodities markets and require a fund, like other commodities markets customers, to deposit margin (cash or other investment assets) to protect market participants against the fund's not making good on adverse fluctuations in the fund's trades.

A commodities customer normally posts the margin with a futures commission merchant (FCM)—a commodities market

broker. There is, however, some risk of loss on a margin deposit if an FCM goes bankrupt.

The SEC permits mutual funds to deposit margin directly with FCMs that are registered with the Commodity Futures Trading Commission under the Commodity Exchange Act. The fund must, however, promptly recover amounts on deposit which exceed the required margin.

There is no legal requirement for board action, but the board does of course have oversight responsibility for all fund operations, including these. Given the risk of loss with futures and options, the board should require management to provide persuasive justification for making any commitments to these instruments. The board should review a fund's experience with futures and options contracts and margin deposits at least quarterly.

Cash. A mutual fund may maintain checking accounts with banks. Aggregate balances may not exceed the amount of the fidelity bond coverage for officers or employees authorized to operate the checking accounts.

A fund may also have a petty cash account of not more than \$500. It must operate the account under the imprest system—the authorized amount staying constant and always equalling cash on hand plus expenditure receipts. The fund's board should approve the controls for the account and the fidelity bond coverage for persons with access to the account.

Fidelity Bond Coverage

A mutual fund must carry fidelity bond coverage on officers and employees with access to the fund's securities or cash. Access means not just physical access but also the ability to divert those assets, whether alone or together with others. The fidelity bond must also cover employees of the management or of investment advisers with access to the fund's assets.

A fund can have a separate fidelity bond just for that fund, but the much more frequent practice is for funds within a fund group to participate in joint fidelity bonds.

The independent directors, separately from the board as a whole, have particular responsibilities for passing on the adequacy of a mutual fund's fidelity bond coverage.

FIDELITY BOND COVERAGE

Board of Directors Action:

- ▲ *A majority of a fund's independent directors* must approve at least annually, taking into account the nature of the fund's portfolio, custody arrangements, and the like:
 - The amount and form of the fund's fidelity bond, whether separate or joint.
 - If the bond is joint, the portion of the premium to be paid by the fund, taking into account the number and activities of the other insureds, ratable allocation of the premium, premium savings, and the like.
 - If the bond is joint, an agreement between the named insureds regarding joint recoveries on joint losses.
- ▲ The board must receive at least 45 days notice of any cancellation or amendment of the bond.
- ▲ Management must promptly give the board information about:
 - The making of any claim under the bond.
 - The proposed settlement of any claim.
 - Any loss under a deductible arrangement with the management.

Other Features:

- ▲ SEC rules provide a schedule of minimum amounts for the bond based on the fund's size. A joint bond must equal at least the aggregate of the coverage amounts required for each fund covered.
- ▲ A bond must provide for at least 60 days notice of cancellation or amendment.
- ▲ The SEC permits bond deductibles up to \$50,000 if the fund's management indemnifies the fund against deductible losses and secures the indemnification.

- ▲ If the bond is joint, the fund and the other insureds must agree that if there is a joint recovery, the fund will receive a share equal at least to what the fund would have received if it had maintained a single minimum bond.
 - ▲ If the bond is joint, the bond carrier must furnish each fund with information as to claims by and settlements with other funds or insureds.
 - ▲ The fund must file information with the SEC concerning the bond, premiums, any premium sharing, any joint insured agreement, and claims.
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Other Insurance

Most mutual funds also carry “errors and omissions” coverage to guard against negligent mistakes which do not trigger fidelity bond coverage but result in financial loss. This coverage is not required under the 1940 Act.

Since mutual funds do not have their own offices and payroll, they do not need to carry standard business coverages, such as liability, casualty, and workmens compensation insurance. It is usual, however, for funds to be named as additional insureds in the management’s own liability policies.

LEGAL REFERENCES

The federal requirements for the custody and safekeeping of mutual fund investments are in Section 17(f) of the 1940 Act and SEC Rules 17f-1 to 17f-6.

The federal requirements for fidelity bond insurance coverage for mutual funds are in Section 17(g) of the 1940 Act and SEC Rules 17g-1 to 17g-2.