

Managing Risk In Processing Corporate Actions

A Study of Operational Risks
and Procedures in the
Processing of Issuer Tender
Offers, Rights Offers and
Other Corporate Actions

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Introduction and Executive Summary

In recent years, ICI Mutual Insurance Company, a Risk Retention Group (“ICI Mutual” or the “Company”) has seen an increase in claims involving errors or oversights by fund complexes in responding to issuer tender offers, rights offers, exchange offers and other “corporate actions” affecting portfolio securities held by managed funds and private advisory accounts. Over the past five years, ICI Mutual insureds have incurred reported losses of more than \$12 million on such claims. It is unlikely that the information available to ICI Mutual reflects the full extent of corporate action processing mishaps that have affected the Company’s insureds. It is probable that there have been additional processing errors and oversights that have resulted in losses to fund complexes — losses that have gone unreported to the Company, or that have fallen below the insured’s retention under its insurance policy, or that have been resolved informally among affected parties without resort to insurance coverage.

In light of these developments, ICI Mutual, at the direction of its Board of Directors, has conducted this study on managing corporate risk (“Study”). The Study complements earlier efforts by ICI Mutual to assist insureds in their risk management efforts in this difficult and technical area.¹ As part of the Study, the Company’s staff has completed forensic analysis of each of the corporate action claims presented to the Company, and has conducted detailed interviews with representatives of a number of fund complexes and custodians. ICI Mutual extends its appreciation to these participating complexes and custodians for their willingness to share information on their corporate action experience and procedures.

The Study focuses on the processing of “voluntary” corporate actions—i.e., corporate actions requiring affirmative responses from fund complexes within designated time periods. Processing of voluntary corporate actions appears to present a significantly more serious risk of loss to fund complexes than does processing of more common “mandatory” corporate actions. The Study seeks (1) to identify the particular stages in the processing of corporate actions where errors and oversights are most likely to occur, and (2) to describe various approaches to managing corporate action risks.

The Study should not be viewed as proposing a single recommended structure or set of “best practices” for use in addressing corporate action risks. ICI Mutual does not believe it is feasible or sensible to seek to develop a *de facto* standard for behavior in this area. Managing the risks inherent in processing corporate actions presents unique challenges for fund complexes, and the approaches used by particular complexes will necessarily depend upon many factors, including complex size, investment focus, and compliance philosophy.

ICI Mutual believes that it is important for senior management at fund complexes to be cognizant of the risks involved in processing corporate actions. ICI Mutual also believes that it is important for senior management to take steps to ensure that appropriate personnel review existing corporate action procedures, with an eye towards formulating revised procedures where warranted. As detailed in the Study, several key themes emerge from the analysis of corporate action claims and survey of corporate action procedures:

- *Corporate Action losses typically arise from simple errors or oversights.* Although corporate action processing is a difficult and technical operational area, the actual errors and oversights that lead to losses are frequently very basic. A hurried portfolio manager mistakenly checks the wrong box on a tender offer response form. A miscommunication between two individuals leaves each believing that the other will take responsibility for shepherding a corporate action request through to completion. A member of the support staff fails to notice that a corporate action response form has not been sent to the custodian.

- *Corporate action losses can result in significant expense, and may have adverse effects on advisory client relationships.* Corporate action losses are frequently expensive. Several of the corporate action claims paid by ICI Mutual have involved losses to fund complexes exceeding \$2 million. Others have involved losses in the high six-figures. Moreover, remedying the economic impact of the mistake may not redress its reputational impact.

- *Written procedures assist in establishing effective and comprehensive systems for processing corporate action requests.* Formulation of comprehensive procedures for processing corporate actions and reduction of these procedures to writing can assist complexes in structuring systems for processing corporate actions in a uniform, consistent and timely fashion. By engaging in the exercise of formulating and regularly reviewing such procedures, fund complexes can also help ensure that special operational issues are identified and discussed by all interested personnel within the complex, and that satisfactory mechanisms are established to resolve any such special issues.

- *Centralization of corporate action processing functions can reduce the frequency of errors and oversights.* Processing corporate actions may require coordination among various departments within a complex, including portfolio management, legal, and fund accounting. Establishing a centralized department or other centralized approach for processing corporate actions (1) makes the review and processing of such actions more efficient, (2) reduces the risk that corporate actions will be overlooked or mishandled, (3) permits consolidation of personnel and development of expertise, (4) assists in coordinating corporate actions affecting multiple accounts within the complex, and (5) helps to ensure that all required responses to corporate actions are timely acted upon and that applicable response deadlines are met.

Managing Risk in Processing Corporate Actions

The term “corporate actions” refers to various types of actions, taken by securities issuers in their corporate capacities, that may have economic impacts on the holders of the issuers’ securities. Corporate actions can be initiated by both domestic and foreign issuers, and can affect both equity and debt securities. Regardless of the particular type of security involved, corporate actions processed by fund complexes can be broadly divided into two types: “voluntary” and “mandatory.” Voluntary corporate actions — which include issuer tender offers, rights offers, exchange offers, and similar types of events — involve a planned action by an issuer under which the holder of the affected security has a *choice* regarding whether to participate in the proposed action, and under which the holder must *respond* within a specified period if the holder elects to participate. By contrast, mandatory corporation actions — which include cash dividends, stock dividends, spinoffs, mergers, issuer name changes, and similar types of events — involve a planned action by an issuer under which the holder of the affected security has *no* choice as to whether to participate in the proposed action, and under which *no* response from the holder is requested or required for participation to be effective.

Although there is certainly a potential that losses may result from the mishandling of mandatory corporate actions, it has been ICI Mutual’s experience that mandatory actions do not generally lead to losses sizeable enough to generate insurance claims.² Rather, insurance claims typically arise from errors and oversights in the processing of *voluntary* corporate actions.³ Such losses can be significant, as evidenced by the fact that ICI Mutual’s insured have incurred more

than \$12 million in losses over the past five years on reported claims involving voluntary actions. It is likely that additional sums have been incurred by fund complexes in this area, but have gone unreported.

The purpose of this Study is to assist fund complexes in (1) understanding why a compliance focus on processing voluntary corporate actions is warranted, (2) identifying the particular stages in the processing of voluntary corporate actions where errors and oversights are most likely to occur, and (3) designing approaches —tailored to the complex’s own particular circumstances and needs — for managing corporate action risk.

The Study is divided into two parts:

- Part I presents general observations relevant to managing corporate action risks, particularly risks associated with voluntary actions. These observations are based on ICI Mutual’s detailed analyses of each of the corporate action claims made by insureds, as well as on information provided by fund complexes and custodians in interviews with ICI Mutual.
- Part II discusses operational objectives that appear to be common to processing voluntary actions, regardless of the size or structure of the complex or the volume of corporate actions received. In discussing these objectives, Part II also includes descriptions of claims received by ICI Mutual, as well as information on some of the approaches to achieving these objectives used by fund complexes.

General Observations

Based on analyses of losses sustained by ICI Mutual insureds and information provided by fund complexes and custodians, a number of general observations may be made regarding the risks associated with processing voluntary corporate actions. These observations are presented and discussed below.

Errors or Oversights

Most losses associated with voluntary corporate actions arise from simple errors or oversights. These errors and oversights can result in significant expense, and may have adverse effects on advisory client relationships.

Although there are difficult and technical issues involved in processing voluntary corporate actions, the actual errors and oversights that lead to losses in this area are frequently very basic. The precipitating cause of a corporate action processing mishap is usually simple human error, in the form of a lapse of concentration, a misunderstanding between personnel, or momentary inattention. Yet a single error or oversight, if not timely detected and remedied, can result in a significant loss for the fund complex. The truth of these statements is evidenced by a brief description of several corporate action claims received by ICI Mutual in recent years:

- A portfolio manager, intending to reject a below-market tender offer for bonds held by four managed funds, inadvertently checks the “accept” box on the tender response form. By the time the discrepancy between market price and tender price is noticed, it is too late to withdraw the tender. **Loss: \$750,000.**⁴
- A portfolio manager misunderstands the various “ratios” for obtaining and exercising rights described in materials for a rights offering by a foreign portfolio issuer. The portfolio manager mistakenly assumes that he has received the right to purchase one new share for each share of the security held by the fund. The manager elects to subscribe fully to the offer, in the mistaken belief that he will double his fund’s position in the affected security. In fact, the terms of the offer establish that holders will receive *thirty-five* rights for each share held, with each right permitting the purchase of an additional share. As a result, the fund’s position in the underlying security is increased by a factor of 35, leading to the fund’s inadvertent violation of guidelines which limit the fund’s investment in a single issuer to 5% of the fund’s assets. **Loss: \$900,000.**
- A supervisor of fund accounting and compliance, after being advised that several managed accounts are eligible to participate in a class action settlement, forwards a note to the complex’s compliance manager, seeking help in managing the responses to the class action settlement offer. After discussion, each of the two individuals is left with the impression that the other will follow up on the matter. By the time the oversight is discovered, the deadline for participating in the class action settlement has passed and the proceeds of the settlement have been distributed. Accordingly, the accounts are unable to obtain any proceeds from the settlement. **Loss: \$1.2 million.**
- A portfolio manager, after discovering that rights held by two managed accounts during a pending rights offering cannot be sold, instructs the

corporate action department to subscribe to the offering. The written subscription instruction is completed and placed in the document file maintained by the complex's corporate action department personnel, notwithstanding the absence of a date/time stamp to evidence that the instruction has in fact been faxed to the accounts' custodian. The complex does not discover that the instruction was never transmitted to the custodian until after the expiration of the subscription period. **Loss: \$900,000.**

As the examples above suggest, corporate action errors and oversights can be expensive. Moreover, remedying the economic impact of corporate action mistakes may not address their reputational impact.

Low Volume High Risk

Most complexes process a relatively small number of voluntary corporate actions. The number is even smaller if the focus is limited to voluntary corporate actions that present a significant potential for economic loss if mishandled.

For most complexes, the volume of mandatory actions received on portfolio holdings greatly exceeds the volume of voluntary actions received. Accordingly, on a relative scale, the number of voluntary corporate actions received by fund complexes appears to be small.

The number of voluntary corporate actions received by fund complexes is even smaller when one focuses solely on those types of voluntary corporate actions that present the most significant potential for economic loss if mishandled. Thus, for example, for many complexes, proxy solicitation materials comprise a significant percentage of all voluntary corporate actions received. Although proxy solicitation materials received from issuers of portfolio securities must obviously be

processed carefully and in accordance with applicable procedures and regulations, errors or omissions by a fund complex in processing such materials are less likely to result in immediate and direct economic harm to the complex than are errors or omissions in processing more "direct impact" types of voluntary actions — i.e., issuer tender or repurchase offers, exchange offers, rights offerings, and class action litigation settlements.⁵ Similarly, certain other types of voluntary corporate actions, such as elections to receive dividends in cash or stock, appear to present a lesser risk of immediate and direct economic harm to the complex than do the more "risky" types described above.⁶

Given the relatively small number of "direct impact" voluntary actions processed by fund complexes, it appears that managing volume should not present a major challenge to fund complexes seeking to reduce overall risk of loss in this area. Rather, as discussed below, the major challenges are more likely to arise from the fact that processing voluntary corporate actions frequently require departments within a complex to coordinate efforts to collect, disseminate, retrieve and return detailed information within a very limited period of time.

Centralization

Centralization of the corporate action processing function can help to reduce errors and oversights in the processing of voluntary actions, and can help to timely detect those errors and oversights that do occur.

The processing of voluntary corporate actions requires fund complexes to make considered investment decisions and to accurately complete and return paperwork reflecting these decisions, all within the context of unforgiving and frequently tight response

deadlines established by outside parties. The process often requires consultation and coordination among personnel in various departments within a complex, including portfolio management, fund accounting, and legal/compliance. *Centralization* of the corporate action processing function assists in establishing clear lines of responsibility and authority for the various steps that must be taken to process and return voluntary actions. Centralization helps to make the review and processing of voluntary actions more efficient, and reduces the risk that incoming corporate actions will be misplaced, misrouted or overlooked. Centralization also helps to ensure that *all* advisory accounts affected by a corporate action will be identified and that responses will be obtained and timely returned for each affected account, and that applicable response deadlines will be met. In addition, particularly where multiple accounts are affected by a corporate action, centralization reduces the risk that individual decision makers for the accounts will act based on misinformation, or that any misunderstandings by individual decision makers will go uncorrected.

Centralization also ensures that those particular individuals within the complex who are involved in corporate action processing will handle a sufficient number of voluntary actions to develop expertise in the area. Whether they work on corporate actions full-time or as part of their other duties, individuals who are specially trained and experienced in processing corporate action requests are likely to be better equipped (1) to analyze different types of requests, (2) to identify unusual requests and to obtain assistance as necessary in understanding their terms, (3) to coordinate obtaining responses for requests affecting multiple accounts within the complex, and (4) to ensure that responses are timely acted upon for all affected accounts.

Some complexes, depending upon the volume of corporate actions received, may centralize corporate action processing in separate corporate action departments, with dedicated full-time staff. Others, particularly smaller complexes, may create working groups, consisting of selected operations, fund accounting, and/or legal/compliance personnel, to coordinate corporate action processing as part of their overall duties. At one complex interviewed, for example, corporate action processing (other than proxy solicitation materials and class action settlements, which are handled separately) is centralized at the securities administration group within the operations department. This group consists of two corporate action specialists and a manager (who also oversees pricing and certain other activities). At another complex interviewed, corporate action processing is centralized within a “corporate action” subgroup consisting of four operations department personnel and one representative from the legal department, each of whom also has other responsibilities. At a third complex, corporate action processing is centralized within the operations group, with one sub-group responsible for fixed-income corporate actions (among other responsibilities), and another sub-group responsible for “voluntary” corporate actions affecting equity securities (among other responsibilities).

Two insurance claims received by ICI Mutual in recent years underscore the severity of the risks associated with decentralization of the corporate action processing function:

- In one claim, advisory personnel mishandled the processing of client account responses to a “dutch auction” tender offer by a portfolio issuer. More specifically, at the directive of the portfolio manager responsible for all client account investments in the security at issue, all accounts were instructed to

tender their shares in response to the offer, which was structured to provide the holders with a premium over market value, with the amount of the premium dependent on various factors. Portfolio administrators for the accounts holding the security were charged with completing and returning tender offer response forms prepared by the various custodians for the accounts. Because shares tendered “conditionally” in response to the offer risked not being accepted for repurchase if the offer was oversubscribed, the intention of the portfolio manager’s directive — as expressed in a belated e-mail to the portfolio administrators — was for shares to be tendered “unconditionally.” An “unconditional” tender would assure that a prorated portion of the tendered shares would be accepted for repurchase if the offer were oversubscribed. In the absence of a timely and clear directive as to whether to tender their shares “conditionally” or “unconditionally,” portfolio administrators for some accounts tendered shares “unconditionally,” as intended by the complex. However, portfolio administrators for three accounts directed the relevant custodians to tender the accounts’ shares “conditionally.” The portfolio administrator for a fourth account failed to respond to the offer at all. The offer was ultimately oversubscribed, and as a result, none of the shares tendered by the four accounts were accepted for repurchase. *Loss: \$2.8 million.*

- In a second claim (previously referenced), several managed accounts surrendered the opportunity to receive proceeds from a settlement of class action litigation against the issuer of a portfolio security, when personnel at the fund complex failed to respond to the class action settlement offer in a timely fashion. In part, the failure to respond resulted from a miscommunication between the complex’s

supervisor of fund accounting and compliance and the complex’s compliance manager as to which of them would follow up on a notice received regarding the settlement offer. However, there were also indications that the complex may thereafter have separately received additional notifications regarding the settlement offer. By the complex’s own admission, no formal or written procedures were in place with respect to receipt and processing of class action settlement notices, and no formal log-in, reporting or follow-up methodology was in place. By the time the oversight was discovered, the deadline for participating in the class action settlement had passed and the proceeds of the settlement had been distributed. Accordingly, the accounts were unable to obtain any proceeds from the settlement. *Loss: \$1.2 million.*

Each of these claims illustrates a number of different types of processing errors and gaps in procedures. As immediately relevant, however, the claims also highlight the risks associated with decentralization of the corporate action process. In the first claim, centralized processing of completed response forms would likely have enabled the complex to uncover the inconsistency in responses as between “conditional” and “unconditional” tenders prior to the submission of the response forms to the custodians. Moreover, the complex would also likely have timely discovered that one of the affected accounts had not yet responded to the tender offer at all. In the second claim, centralized processing would have clarified the chain of responsibility for responding to the class action settlement notice, thereby reducing the likelihood of misunderstandings between personnel. Centralization would also have assisted the complex in tracking the status of the complex’s responses to the notice. Such centralized tracking would likely have alerted the complex, prior to the applicable deadline, of the fact

that a response had not yet been filed. Finally, centralized processing would likely have ensured that the subsequent additional notices, once received, were followed up on by responsible individuals, and would thus likely have provided a second mechanism for discovering that a response to the class action settlement offer had not yet been filed for affected accounts.

Written Procedures

Development of detailed written procedures can help to reduce errors and oversights in the processing of voluntary actions, and to detect those that do occur.

It is likely that some complexes utilize *ad hoc* approaches to processing of voluntary corporate actions. Others may be utilizing outdated procedures that fail to reflect more recent structural changes in the complexes, growth in number of managed accounts, or increases in the volume of corporate actions received. If complexes are using such *ad hoc* or outdated techniques, there are readily identifiable reasons. First, the relatively low volume of voluntary corporate actions received by most complexes and the relative lack of publicity over corporate action errors and losses may have lulled some complexes into the mistaken belief that corporate action compliance is a low risk area. Second, given that corporate action processing typically requires the involvement of personnel from various departments within a complex — including portfolio management, fund accounting and legal — it may be difficult for senior management to identify the appropriate department within the complex to “take ownership” of the process. Finally, absent interest and support from upper management, a single department, acting alone, is unlikely to have sufficient information or resources to initiate a systematic review of *ad hoc* or outdated corporate action procedures.

ICI Mutual believes that perhaps the most effective single step that senior management can take to reduce corporate action risk is to insist that appropriate personnel *establish a set of updated procedures* for the processing of voluntary corporate actions. While the complexity and detail of the procedures may vary depending on the needs of the particular complex, the exercise of establishing updated procedures should include (1) a systematic analysis of the corporate action process by appropriate personnel from affected departments; (2) the formulation by the complex of comprehensive procedures, tailored to the particular needs of the complex, for processing corporate actions; (3) appropriate supervisory review of these procedures; and (4) the reduction of these procedures to writing. The formulation of updated procedures is important even for those complexes that rely heavily on custodians or other third parties for assistance in processing corporate actions, particularly since such third parties may ultimately have no legal obligation in the event that the complexes sustain significant corporate action losses.⁷

There are a number of benefits to be gained from formulation of written procedures in this area. By developing and instituting formal written procedures, complexes can structure systems to process voluntary corporate actions in a uniform, consistent and timely fashion. Such systems can reduce the number of errors and oversights in the processing of corporate actions, and can timely correct at least some of those errors and oversights that do occur. Moreover, the effectiveness of such systems, once created, is not dependent on the “institutional memory” of key individuals at the complex, nor on the good graces of custodians or other third parties who may have no legal obligation to assist the complex in its corporate action processing functions. Finally, by engaging in the exercise of formulating and regularly reviewing written procedures,

fund complexes can help to ensure that special operational issues are identified and discussed by all interested personnel within the complex, and that satisfactory mechanisms are established to resolve any such issues.

Operational Objectives

In formulating procedures for processing voluntary corporate actions, fund complexes should consider how best to achieve a number of general operational objectives.

Based on analyses of claims and interviews with fund complexes and custodians, it appears that there are certain operational objectives common to processing voluntary actions, regardless of the particular structure of the complex or the volume of corporate actions received. ICI Mutual believes that in the course of formulating procedures for processing voluntary actions, fund complexes should give consideration to how best to achieve these various operational objectives, as well as any other objectives that may be identified by the complexes themselves.

Given the widely divergent natures of fund complexes, it is unrealistic to propose any uniform *means* for achieving these objectives. Managing the risks inherent in processing corporate actions presents unique challenges for fund complexes, and the specific approaches and procedures used by particular complexes will necessarily depend upon many factors, including the complex's size, operational structure, investment focus, and compliance philosophy. Accordingly, it is not the Study's intention to propose a single set of "best practices" for use in addressing corporate action risks. Indeed, ICI Mutual does not believe it is feasible or sensible to seek to develop a *de facto* standard for specific behavior in this area.

However, ICI Mutual believes that in developing their own specific approaches to managing corporate action risks, complexes can benefit significantly from considering certain operational objectives, and from considering how these objectives may be achieved. These objectives, which are discussed in more detail in Part II of this Study, can be summarized as follows:

- Is the complex obtaining all relevant terms and information on voluntary corporate actions affecting portfolio securities held by managed funds and accounts?
- Are appropriate safeguards in place to ensure that *all* of the funds and advisory accounts that hold the affected security are being identified?
- Are appropriate safeguards in place to ensure that relevant terms and information on the corporate action are fully understood by the decision makers for the affected accounts and funds, and that response forms for the corporate action are completed as intended by them?
- Are appropriate safeguards in place to ensure that responses are prepared and returned on behalf of *each* affected account or fund within the time period established?
- Is appropriate documentation being maintained to assist in achieving the foregoing objectives, and to evidence that each objective has been met?

Safeguards

Establishing safeguards can reduce the likelihood that errors and oversights will result in losses.

Human errors and oversights are inevitable. It is unrealistic to expect that an organization can

completely eliminate them. Risk prevention efforts, however, are built on the premise that organizations can take steps to *reduce* the likelihood that employee errors or oversights will occur, and to *reduce* the likelihood that the errors or oversights that do occur will go undetected and uncorrected. In the corporate action context, this may involve various supplementary efforts in addition to formulation of procedures. Such supplemental efforts may include, for example, periodic initiatives to educate supervisors and line employees on corporate action risks, and to ensure that these individuals understand the scope of their responsibilities and the possible effects of their failure to satisfy those responsibilities.

In recognition that employee errors and oversights are inevitable, complexes should also give consideration to

the types of procedural *safeguards* that can be instituted to timely detect errors and oversights that do occur, so that appropriate remedial measures can be taken before the errors or oversights result in losses. Several complexes and custodians have stressed their belief that given the complexities and time pressures involved in processing corporate actions, it is important to establish *multiple* safeguards, wherever feasible, for detecting errors and oversights. Built-in redundancies in the processing of corporate actions — such as seeking confirmation from a second source of the terms of unusual or complicated corporate action requests, and requiring reviews by persons other than the decision makers of completed corporate action response forms for consistency and accuracy — can be highly effective in detecting and correcting human errors and oversights before losses are incurred.

Common Operational Objectives

Analyses of claims and interviews with fund complexes and custodians suggest that there are certain operational objectives common to processing voluntary actions, regardless of the particular structure of the complex or the volume of corporate actions received. Given the variations among fund complexes in size, operational structures, investment focuses, and compliance philosophies, it is unrealistic to expect complexes to adopt identical mechanisms for achieving the objectives discussed below. However, in recognition that complexes may benefit from more concrete examples of techniques used in the industry, Part II of the Study provides some general information on how some fund complexes seek to achieve these objectives.

Relevant Terms and Information

Is the complex obtaining all relevant terms and information on voluntary corporate actions affecting portfolio securities held by managed funds and accounts?

A fund or advisory account in a fund complex may be adversely impacted if the complex (1) remains unaware of the existence of a voluntary corporate action request affecting portfolio securities until after the deadline for responding to the request has passed, or (2) receives timely notice of the action but relies on incomplete or inaccurate information in formulating a response to the request. Accordingly, in developing procedures for processing voluntary corporate action requests, fund complexes may wish to consider what

reasonable measures and safeguards may be taken to reduce risks in these two areas.

PRO-ACTIVE EFFORTS TO LEARN OF THE EXISTENCE OF VOLUNTARY ACTIONS

Pro-Active Efforts Include:

- Using Electronic Feeds and Vendor Services
- Polling Portfolio Managers, Traders and other Internal Personnel
- Subscribing to Publications

Many fund complexes appear to rely primarily or even exclusively on their custodians to notify them of the existence of voluntary corporate action requests affecting portfolio securities held by managed funds and accounts.

In the case of domestic securities, such reliance may not be unfounded, given the extensive disclosure requirements placed on domestic issuers by U.S. law and the efficient market incentives in the U.S. that promote collection and distribution by service providers to mutual fund complexes of timely information on newly-declared voluntary actions.⁸ In many foreign markets, however, these same factors may not be in place.⁹ As a result, it may be more difficult for custodians themselves to become aware in a timely fashion of all voluntary corporate actions affecting foreign securities held by the complex's managed funds and accounts.

To address this risk, some fund complexes have instituted supplementary, pro-active measures to seek out information on forthcoming voluntary corporate actions. Examples of some of these measures and safeguards include the following:

- Fund complexes may subscribe to one or more electronic feeds or other vendor services that

provide, among other things, independent information on issuers in particular markets or on issuers of particular types of securities. Some complexes have invested in automated techniques that permit them to download into vendor systems the identification numbers for the complex's master list of securities holdings, so as to extract on a regular basis all new corporate action information available from the vendor systems regarding any of those securities. The number of different services to which a fund complex may subscribe is likely to vary, depending upon the complex's investment focus, size, and other factors. Again, this type of pro-active measure can be particularly important for complexes investing in foreign markets.

- Portfolio managers, analysts and traders at fund complexes may frequently have their own sources of rumors and news on upcoming corporate actions. In recognition of this fact, corporate action personnel at some complexes have instituted mechanisms to "poll" these personnel on a regular basis, in an effort to obtain informal advance notice of actual or potential corporate actions by issuers of portfolio securities.
- Settlement terms of class action lawsuits, at least those involving domestic issuers, frequently require notice of the settlement to be published. Fund complexes may monitor these settlement opportunities through subscriptions to *Securities Class Action Alert*, or similar publications or sources that report on shareholder litigation. Given the public availability of information on many class action settlement opportunities, some complexes may view monitoring a reasonable number of such publications to be prudent, and consistent with their general fiduciary obligations to their managed funds and accounts.

PRO-ACTIVE MEASURES TO OBTAIN ALL RELEVANT TERMS AND INFORMATION ON VOLUNTARY ACTIONS

Pro-Active Measures Include:

- Comparing Notices to Other Available Information
- Reviewing Underlying Issuer Documentation
- Comparing Information Received from Various Custodians

Custodians typically provide notices of voluntary actions in *summary* form. These notices seek to highlight relevant terms and information regarding the voluntary corporate action at issue.¹⁰ The notices may be based solely on secondary information received from the Depository Trust Company (in the case of actions affecting domestic securities), foreign subcustodians (in the case of actions affecting foreign securities), and/or other entities. Fund complexes should not expect that the custodian, in preparing the notice, has necessarily received and reviewed the underlying documentation on the action prepared by the issuer.¹¹ Nor should fund complexes expect that the information on which the notice is based has necessarily been confirmed by a second source.¹² Moreover, because the custodian's notices on individual corporate actions tend to be prepared by mid-level administrative personnel at the custodian, who may themselves be working under severe time pressure, complexes should not expect that the summary information provided has necessarily been thoroughly vetted or reviewed by high-level personnel at the custodian.

As a result, there is always a risk that a custodian's notice may contain information that is materially incomplete or inadvertently misleading. Additional "cross-cultural" risks are introduced by foreign actions,

where unusual or unfamiliar language or terms used by subcustodians in providing information to the custodian may result in notices that are ambiguous or confusing to American ears.

There are similar risks associated with use by fund complexes of custodian-prepared response forms — i.e., forms prepared by a custodian and completed and returned by the fund complex to direct the custodian as to how to respond on behalf of affected funds or accounts to the corporate action notice. As with the notices themselves, response forms may be ambiguous or inadvertently misleading with respect to options available to the security holder, particularly where the corporate action is an unusual one.

To address these risks, some fund complexes have instituted pro-active measures and safeguards similar to those used for seeking out information on new actions. Examples of these measures and safeguards include the following:

- Some complexes make concerted efforts to *confirm* all relevant terms and information in a custodian's notice (or response form), by comparing the notice (or response form) to descriptions of the corporate action provided by one or more additional sources (e.g., vendors, analysts, and perhaps even the issuer itself in appropriate cases). Some complexes seek, where feasible, to obtain more than one outside confirmation.
- Some complexes may seek to obtain and review copies of the underlying documentation prepared by the issuer wherever feasible, or at least where the voluntary corporate action is unusual and time permits. Copies of the underlying documentation may not be provided by the custodian with its notice, but may frequently be available from the custodian upon request. Particularly in the case of domestic

securities, such documentation may also often be accessible through on-line sources.

- Where multiple custodians supply notices to a single fund complex on a single voluntary action — as is frequently the case where several custodians serve different funds and accounts within a complex — it may be prudent for appropriate personnel at the complex to compare the different notices and response forms received in order to identify any ambiguities or inconsistencies between relevant terms and information as described by the various custodians.

Appropriate Safeguards

IDENTIFY THE AFFECTED FUNDS AND ADVISORY ACCOUNTS

Safeguards Include:

- Using Automated Identification Techniques
- Reconfirming Positions as of the Record Date
- Applying Special Measures for Class Action Settlement Notices

As discussed above, custodians normally provide notice of pending corporate actions to affected funds and advisory accounts. Complexes may also learn of corporate action opportunities through other sources (as, for example, in the case of class action settlements, where complexes may learn of opportunities through specialized publications such as the *Securities Class Action Alert*.) Information on a single corporate action may become available from different sources at different times, however. Moreover, in some cases, because different custodians are involved or otherwise, it is possible that information on a single action will be transmitted to some affected funds or accounts within a complex, but not to others.

Upon receipt by a single fund or advisory account of notice of a pending action, it is important that the complex take appropriate steps to promptly identify *all other* funds and accounts holding the affected security during the period relevant to the action. By adopting measures and safeguards to ensure such prompt identification, a complex can reduce the risk that corporate action opportunities will be overlooked for one or more affected funds or accounts. This might occur, for example, if custodians fail to transmit individual notices to one or more affected funds or accounts, or if the complex misplaces or overlooks one or more individual notices on the action received from custodians.

Some fund complexes appear to rely on very informal mechanisms to identify the universe of funds or accounts potentially affected by a voluntary action. Thus, for example, some complexes may rely solely on a head trader's knowledge of positions held by the complex's funds. These types of informal systems are generally less effective than more formal systems. Informal systems tend to be dependent on the "portfolio memory" of a limited number of key individuals. Because such individuals may sometimes be absent or incapacitated, or simply preoccupied, there remains a risk that informal mechanisms may fail to provide an adequate safeguard against oversights in identifying the full universe of potentially affected funds and accounts.

Other complexes utilize automated systems to identify the universe of funds and accounts potentially affected by a pending action. Such automated systems may permit lists of positions and accountholders to be run for each specified security (whether identified through CUSIP number or otherwise). Automated techniques can thus remove much of the potential for human oversight inherent in more informal systems.

Regardless of the type of system used, it is important to make appropriate provision to identify those funds and accounts within a complex that hold the specified security *as of the record date* for the corporate action. Thus, for example, where a corporate action notice is received that specifies a *future* record date, a complex may find it necessary to preliminarily identify all funds and accounts potentially affected, and later *to reconfirm and as necessary revise* this information as of the record date. Indeed, even if the identities of affected funds and accounts do not change, the *holdings* of these funds and accounts in the affected security may change during this interim period.

Class action settlement notices present special operational issues for fund complexes in this regard. Class action settlements will typically require fund complexes to ascertain whether particular securities were *historically* held by any funds or managed accounts — i.e., during specified “class periods” in earlier years. Accordingly, different measures may be required in order for complexes to identify the universe of funds and accounts affected by this type of action.

DECISION MAKERS HAVE RELEVANT TERMS AND INFORMATION & RESPONSE FORMS ARE COMPLETED AS INTENDED

Safeguards Include:

- Centralized Review of Completed Response Forms

Clearly, if portfolio managers or other relevant decision makers for affected accounts and funds do not fully understand the relevant terms and information for a corporate action, they may formulate “unintended” responses to corporate actions — i.e., they may be unable to make considered and appropriate

determinations as to how to respond to the corporate action on behalf of their managed accounts.

A second category of risk involves errors and oversights that may occur when the complex takes steps to *implement* the decision maker’s intended response — i.e., during the course of the complex’s efforts to complete corporate action response forms so as to reflect accurately the conclusions of the decision makers. Failures to complete response forms as intended by decision makers may be traced, in some cases, to oversights on the part of the individuals charged with filling out the response forms. In other cases, the failures may be traced to ambiguous or incomplete directives received from the decision makers. In still other cases, the failures may be at least partly due to ambiguities or other problems in the response forms themselves.

Several insurance claims received by ICI Mutual highlight these two types of risks:

- A claim involving the mishandling of a rights offering (previously described) illustrates the first type of risk discussed above — i.e., how decision makers may formulate “unintended” decisions on voluntary actions by reason of inattention, unfamiliarity with unusual actions, or otherwise. In this claim, the decision maker, a portfolio manager for a managed fund, overlooked or failed to appreciate the importance of various “ratios” described in the offering materials for obtaining and exercising rights offered by a foreign issuer. The portfolio manager correctly assumed that the offer permitted him to obtain one additional share for each right held, but *incorrectly* assumed that the offer would provide the fund with a *single* right for every share held. Based on these assumptions, the manager elected to fully subscribe to the offer, in the mistaken belief that he would double his fund’s position in the

affected security. In reality, the terms of the offer dictated that holders would receive *thirty-five* rights for each share held. As a result, the fund's position in the underlying security was increased by a factor of 35, leading to the fund's inadvertent violation of guidelines which limited the fund's investment in a single issuer to 5% of the fund's assets.

- A claim involving the mishandling of a tender offer (previously described) illustrates the second type of risk discussed above — i.e., how errors may occur when implementing intended decisions. In this claim, a portfolio manager intended to reject a below-market tender offer for bonds held by four managed funds. Inadvertently, however, the portfolio manager, in completing the response form, checked the “accept” box rather than the “reject” box. By the time the discrepancy between market price and tender price was noticed, it was too late for the offer to be withdrawn.
- A claim involving a complex “dutch auction” tender offer (previously described) illustrates aspects of both types of risk discussed above. In this claim, the ability of various managed accounts to participate in the issuer's oversubscribed “dutch auction” tender offer turned, as here relevant, on whether the accounts had indicated their willingness to participate in the offer “unconditionally” rather than “conditionally.” It is not clear whether the portfolio manager charged with making the tender decisions for the accounts reviewed the underlying documentation provided by the issuer, or was familiar with the key distinction between tendering “unconditionally” and “conditionally.” In any event, the portfolio manager gave an ambiguous tender directive to the individual portfolio administrators for the various advisory accounts holding the affected security. These administrators were charged

with completing, for the individual accounts administered by them, tender response forms prepared by various custodians. In completing these forms — some of which were not themselves clear in distinguishing between the available tender options — some of the administrators directed that their accounts' shares be tendered “conditionally,” which resulted in these accounts being precluded from participating in the oversubscribed offer. It appears that the administrators for these accounts either overlooked or were unfamiliar with the distinction between the tender options. Moreover, it appears that none of them reviewed underlying documentation on the offer or consulted with the portfolio manager or the complex's legal department before returning the response forms to the relevant custodians.

The institution of *centralized secondary reviews* of completed response forms can be an effective mechanism for reducing risks in these two areas. In some complexes, such reviews require “sign offs” at the supervisory level, and/or by other departments (e.g., legal) at the complex. Such secondary reviews, when conducted by persons separate from those charged with the decision making and preparation of response forms, can be valuable in detecting and correcting inadvertent errors and oversights that might otherwise result in significant losses to fund complexes. Such reviews can be helpful in managing risks in a number of specific respects:

- When the individual charged with the secondary review is provided with even the most basic information on the action involved, he or she may often be in a position to detect rudimentary errors caused by lapses of attention, such as accepting tender offers at below-market prices or miscalculating rights ratios.

- When centralized secondary reviews involve supervisory and/or legal personnel, they can be even more effective. Supervisory and legal personnel may be more experienced in, or more sensitive to, the potential complexities of certain types of actions. Accordingly, their involvement in the review process may assist the complex in detecting less glaring errors or oversights, such as oversights in whether an account can participate as a qualified institutional buyer in some types of foreign voluntary actions.
- More sophisticated secondary reviews may also assist complexes in detecting the potential repercussions of certain kinds of actions. Thus, for example, such reviews may be structured to require consideration of whether responses, if returned to the custodian as directed, will result in violations by the affected funds or accounts of applicable investment restrictions.
- Centralized secondary reviews permit a complex to compare response forms completed on behalf of multiple funds or accounts with respect to a single corporate action. Inconsistencies between responses for a single action may reflect honest differences of opinion between decision makers for the affected funds and accounts. However, inconsistencies may also reflect (1) a misunderstanding on the part of one or more decision makers as to a key term of the action, or (2) simple errors (that might not otherwise stand out) on the part of the individuals completing the forms. Accordingly, complexes may find it prudent to take steps to detect any such inconsistencies and bring them to the attention of the relevant decision makers for review.

RESPONSES ARE PREPARED AND RETURNED WITHIN THE TIME PERIOD ESTABLISHED

Safeguards Include:

- Establishing Internal Deadlines
- “Real Time” Tracking Status
- Assigning Responsibility for Monitoring

The processing of voluntary corporate actions requires fund complexes to make considered investment decisions on behalf of all affected funds and accounts, to accurately complete response forms reflecting these decisions, and to return these response forms to one or more custodians or other third parties. These steps must all be completed within a period beginning at the complex’s receipt of initial notice of the corporate action, and ending at the deadlines established by the terms of the notice and by the custodians themselves.¹³ The processing period may be relatively short, particularly in the case of voluntary actions involving foreign securities.¹⁴ Further complicating matters is the fact that the processing of a voluntary corporate action typically requires coordination among personnel in various departments at the fund complex, including portfolio management, fund accounting, and perhaps legal. Moreover, because decisions as to how to respond to voluntary corporate actions may be affected by interim developments in the markets, there is an understandable tendency on the part of many decision makers to make corporate action decisions as close to final response deadlines as possible.

These factors create significant operational pressures for fund complexes in processing voluntary corporate actions. Under these pressures, small errors or oversights may be more likely to go undetected, leading to significant repercussions for the fund complex. Accordingly, it is important for complexes to consider

how appropriate measures and safeguards can be put into place to ensure that responses are prepared and returned on behalf of *all* affected funds and accounts prior to the deadlines established by the relevant custodians.

It appears that some custodians will customarily make efforts to place ‘courtesy calls’ to fund complexes if a deadline is approaching and response forms have not been received. Yet the practice does not appear to be universal. Moreover, because custodians are likely to take the position that they have no legal obligation to provide such reminders at all, let alone in all cases, complexes should not rely solely on their custodians to monitor approaching deadlines. Indeed, it may be quite difficult for a complex to turn to a custodian for relief in the event that the complex fails to provide response forms in a timely fashion.

Several of the claims discussed in preceding sections of this Study illustrate the importance of appropriate measures and safeguards to ensure timely preparation and return of response forms for all funds and accounts affected by a corporate action. In one claim (previously discussed), several managed accounts surrendered the opportunity to receive proceeds from a settlement of class action litigation when personnel at the fund complex failed to respond to the class action settlement offer in a timely fashion, in part because of a miscommunication between the complex’s supervisor of fund accounting and compliance and the complex’s compliance manager as to which of them would follow up on a notice received regarding the settlement offer. In another claim (previously discussed), the portfolio administrator for a managed account failed entirely to submit a response form for one of his managed accounts, notwithstanding that he had submitted response forms for other on the same action. This portfolio administrator apparently crossed the account

off his “internal checklist” as if he had in fact responded to the offer, notwithstanding that no response was ever sent. In a third claim (previously discussed), a written subscription instruction was completed and placed in the document file maintained by the complex’s corporate action department personnel without having first been telecopied to the accounts’ custodian. The failure to provide instructions to the custodian was not discovered until after the applicable deadline had passed.

Centralized management of the corporate action process can also be effective in this area. By centralizing management of the process, complexes are likely to have more flexibility to explore the feasibility of utilizing of various kinds of safeguards, including:

- The establishment, upon receipt of an initial notice of a voluntary action, of internal deadlines for completion of each of the following steps: (1) delivery of information to affected decision makers; (2) receipt of directives from the affected decision makers; (3) completion by appropriate personnel of response forms for each affected fund and account; (4) secondary review of completed forms for consistency and for substantive errors (e.g., number of shares held by the particular fund or account); and (5) delivery of completed response forms to relevant custodians prior to applicable deadlines.¹⁵
- “Real-time” tracking of the processing status of each voluntary corporate action. Some complexes use “pending corporate action” reports (which might be on the complex’s computer systems or created manually) for this purpose, and may supplement these reports with “daily calendars” containing reminders of upcoming deadlines.
- Assigning one or more employees within the centralized group the responsibility of monitoring

the processing status of pending corporate actions. These individuals may be further responsible for following up with portfolio managers, administrators, in-house attorneys or relevant personnel as various internal deadlines approach, to ensure that the deadlines are recognized and will be met. These individuals may also be assigned the responsibility of confirming that appropriate documentation for each step of the process is in place.

Appropriate Documentation

Documentation Includes:

- Creating “Pending Corporate Action” Reports
- Maintaining Checklists
- Requiring Written Sign-Offs
- Maintaining Written Evidence of Receipt by Custodians

Is appropriate documentation being maintained to assist in achieving the foregoing objectives, and to evidence that each objective has been met?

Creating and maintaining appropriate documentation can assist complexes in structuring and monitoring the processing of voluntary corporate actions. The use of written “pending corporate action” reports, for example, enables a complex to remain aware at any given moment of the current status of all pending actions, and of the identities of the funds and accounts affected by those actions. The inclusion in these types of reports of a “checklist” of items to be completed helps to ensure that items are not overlooked or forgotten under the time pressures often created in the corporate action process. Documentation can also help to ensure that steps in the process are not overlooked if a key employee involved in the processing function

should suddenly be incapacitated or otherwise unavailable.

Some complexes may require portfolio managers, those reviewing completed response forms and others involved in the process to initial response forms and/or other appropriate documentation to evidence that they have completed their obligations with regard to processing the action. Such requirements ensure that all relevant personnel are consulted during the course of the complex’s preparation and submission of response forms. In addition, such requirements tend to underscore, for the parties involved, the importance of their roles in the process, and may therefore reduce the likelihood of errors caused by lapses of attention.

Perhaps the most critical documentation to be obtained, preserved, and double-checked by fund complexes is documentation evidencing that completed response forms have been timely *received* by relevant custodians. It is likely that in coming years, computer-to-computer systems (such as State Street’s “CapTAIN” system) will replace fax machines as the response mechanisms of choice for fund groups. Such computer-to-computer systems will likely be designed to provide fund complexes with contemporaneous evidence that their transmissions have been received and acknowledged by the custodian.

At present, however, most response forms are still provided to custodians by fax, frequently just prior to applicable deadlines. The use of faxes, particularly under the time pressures often involved in corporate action processing, creates a surprising amount of room for error. ICI Mutual has received multiple reports of losses arising from the apparent failure of fund complexes to fax completed instructions to relevant custodians prior to applicable deadlines.

One of the single easiest, more productive measures that a fund complex may take immediately to reduce risk of loss in the corporate action processing area is to obtain and preserve evidence that response forms for all affected funds and accounts have been received by relevant custodians. In this regard, complexes gain little protection from preserving only the *outgoing* fax materials. Outgoing materials may evidence only that the complex intended to send the instructions, and not that the instructions were in fact sent by the complex and received by the custodian.¹⁶

Accordingly, it is important that complexes focus on the importance of obtaining and preserving the “confirmation sheet” that is produced following the successful transmission of the fax. This confirmation sheet, along with a full copy of the transmitted

materials, provides useful evidence that response forms were timely returned. Such evidence can be invaluable in the event of a dispute between a fund complex and a custodian as to whether instructions on a voluntary corporate action were returned by the applicable deadline.

Some complexes have adopted additional safeguards in this area. For example, some complexes make follow-up telephone calls to the custodian following transmission of response forms, and note the date, time and name of the individual at the custodian who confirms receipt of the materials. Others send “master lists” at the end of each day, identifying all materials provided to the custodian that day, and seeking written confirmation of their receipt.¹⁷

Endnotes

¹ ICI Mutual has responded to corporate action risk with both educational and underwriting initiatives. In the educational area, ICI Mutual previously published a Risk Manager Alert devoted to the topic of managing corporate action risk, and has further highlighted the area at several recent Risk Managers Conferences sponsored by ICI Mutual and attended by risk managers, compliance officers, attorneys and other representatives of insured complexes. In the underwriting area, ICI Mutual's new applicant and renewal applications have been revised to include questions regarding an applicant's procedures for processing corporate action requests.

² However, if a complex acts upon erroneous information as to the effective date of a stock split, for example, or makes a data entry error with respect to the payable date of a dividend, there is a potential for mispricing of affected portfolio securities, and possibly even for mispricing fund shares.

³ Several observations may be made as to the reasons for this disparity in loss experience as between mandatory and voluntary corporate actions. First, there may simply be fewer processing errors and oversights in the case of mandatory actions than in the case of voluntary actions. Because mandatory actions, unlike voluntary actions, do not require preparation, coordination and transmission of responses on the part of the fund complex, there are a reduced number of points in the processing of mandatory actions at which errors and oversights may occur. Second, it may be that mandatory actions lend themselves more readily than do voluntary actions to use of automated compliance techniques to reduce errors and oversights — such as the use of control reports and other mechanisms for isolating and tracking relevant information requiring review, confirmation, and/or correction. Finally, because economic benefits from mandatory corporate actions attach to securities without reference to the holder's actions or omissions, it is less likely that the associated economic benefits can be lost in their entirety.

⁴ "Loss" as used herein is the gross loss amount without regard to insurance or indemnification.

⁵ From time to time, funds or private accounts may be presented with the opportunity to receive economic benefits in connection with settlements of class action litigation involving issuers of portfolio securities. In such cases, securities holders may be required to complete and return documentation by a specified date if they wish to participate in the proposed settlement as members of the plaintiff "class." Advance notice of such settlement opportunities may be provided to security holders by court-appointed settlement administrators or by other third parties, rather than by custodians or the issuers of the affected securities, and the processing by fund complexes of such opportunities may involve different procedures than other types of voluntary corporate actions. One may distinguish between such "class action settlement" opportunities and other types of "voluntary corporate actions." However, because class action settlements frequently require an affirmative response on the part of the security holder in order to obtain the offered economic benefit, and because they present many of the same processing challenges as issuer tender offers and other more traditional voluntary corporate actions, they are treated as such for purposes of this Study.

⁶ In terms of absolute numbers, the number of voluntary corporate actions (excluding proxy solicitations) received by fund complexes also appears to be small. Thus, for example, one mid-sized fund group reports that it has received approximately 125 voluntary corporate action requests (excluding proxy solicitations) during a six-month period. Similarly, a fund accounting agent that provides corporate action processing services to hundreds of funds reported that it received approximately 1600 voluntary corporate action requests (excluding proxy solicitations) during a six-month period, which, when viewed on a per-client basis, is again a relatively small volume. One small fund group, which manages fewer than a dozen equity funds, advises that one of its funds (which it views as typical) has received fewer than two dozen voluntary corporate action requests during the past two years.

⁷ In addition to custodians, outside fund accountants may receive copies of corporate action responses in connection with updating fund account records, and in the course of such activity, may from time to time identify potential issues. At one such provider, for example, more than a dozen employees are involved in corporate action matters on behalf of client accounts. Although they may provide substantial assistance to clients in properly accounting for corporate actions, it appears that such providers are likely to view their client fund complexes as ultimately responsible for the accurate completion and timely return of voluntary corporate action responses.

⁸ The vast majority of domestic securities are held by the Depository Trust Company ("DTC") as registered holder of the affected security. With the exception of information on class action settlements, DTC is likely to receive information on virtually all voluntary corporate actions affecting domestic securities. After DTC receives notice of an imminent voluntary corporate action from the issuer of the affected security, DTC prepares and routes summary information on the action to various parties, including custodial banks for affected mutual funds and advisory accounts. Many times, however, by the time a custodian receives summary information on a

particular corporate action from DTC, the custodian will already have learned of the corporate action from another source (such as a commercial vendor specializing in tracking developments at securities issuers, or from contacts at the issuers themselves). Given the time sensitivity of information on pending corporate actions, the custodian, upon receipt of the information from whatever source, will generally seek as soon as possible to route summary “notices” on the corporate action (or direct DTC to route the information) to pre-designated contact persons (or departments) at affected funds and accounts.

⁹ In the case of voluntary corporate actions by foreign issuers, there is no single entity, such as DTC, to look to as a virtually complete source of information. Indeed, in many foreign markets, custodians are largely, and perhaps sometimes entirely, dependent on their subcustodial networks to provide information on pending voluntary corporate actions. Although custodians may seek to supplement information received from subcustodians with information received from other sources (such as contacts at foreign stock exchanges and commercial vendors specializing in tracking developments in particular markets), it is more difficult to be assured that a custodian is uncovering and providing information on all voluntary actions affecting portfolio securities.

¹⁰ If the deadline established for responding to the voluntary corporate action permits, the custodian may first seek to confirm the information it has received through one or more other sources, before routing the information to affected funds and accounts. The custodian may also seek to send out more than one notice on a single corporate action, particularly if time permits or if the custodian’s information at the time of the first notice remains unconfirmed or incomplete. Thus, for example, a custodian may seek to send out a “preliminary” notice of the pending corporate action almost immediately upon receipt of the initial information, with a follow-up “full” notice sent after the custodian has collected more complete details.

¹¹ Thus, in the case of voluntary corporate actions on domestic securities, DTC apparently does not typically forward to custodians the full underlying documentation on the action prepared by the issuer. These materials may be requested through DTC’s on-line computer system, and the custodians interviewed seem to make it a practice to obtain at least one copy of the issuer’s underlying documentation. While some custodians may review the documentation in order to assist them in creating and validating the summary “notices” provided to their clients, they may not do so in every case. Moreover, it appears that some custodians may be more inclined to provide clients with the same summary information as is provided to them by DTC, although they may perhaps check that information against information on the corporate action provided by a commercial vendor. Custodians have reported that in the case of foreign actions, it may be impossible, as a practical matter, to obtain underlying documentation from the foreign issuer in sufficient time to review that documentation and provide notices to clients prior to the applicable response deadline.

¹² One custodian has advised that it attempts to conduct “second sourcing,” but that “time or market constraints” may prevent such confirmations from being effected.

¹³ Custodians will typically establish their own deadlines, in advance of the deadline specified in the corporate action, for return of completed response forms to the custodians. The custodian’s deadline will frequently predate the deadline established in the action by a few days. While a custodian may accept response forms submitted after the custodian’s established deadline, it typically will not “guarantee” that such late responses will be timely forwarded to the issuer. Indeed, it appears that in at least some cases, such late responses are processed by the custodian only after it has completed the processing of all timely responses received. Accordingly, there are significant risks to a complex in missing deadlines established by the custodian.

¹⁴ In voluntary corporate actions involving foreign securities, it is not uncommon to find delays in the provision of initial notices. In some instances, the response times established by issuers may also be significantly shorter than is typical in domestic markets.

¹⁵ As noted above, custodians typically establish their own deadlines for receipt of response forms. Where multiple custodians are involved on a single action, it is thus possible that the deadlines established by the custodians for receipt of responses may vary. Accordingly, in establishing internal deadlines for responding to corporate action notices, it may be prudent for complexes to take steps to ensure that the earliest applicable deadline has been identified.

¹⁶ Although phone records may in some cases evidence that calls were made from particular numbers at the offices of a fund complex to particular numbers at the offices of a custodian, it may be difficult to prove from these records that particular faxes were sent and received at particular times, especially if there is a high volume of other fax traffic between the two organizations.

¹⁷ Such measures would appear to be useful techniques to assist fund complexes and their custodians in identifying any faxes that might otherwise have been overlooked. However, complexes should recognize that there may also be some risk that such measures could be counterproductive in the event of a loss, unless the complex has been assiduous in applying such measures on a consistent basis and on following up whenever the requested written confirmations were not provided.

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Stability and Financial Strength in All Markets:

consistent coverage and strong capital

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