Comment Letter on SEC Year 2000 Temporary Rule Proposals for Transfer Agents and Broker-Dealers, April 1998

April 13, 1998

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Year 2000 Readiness Reports—File Nos. S7-7-98 and S7-8-98

Dear Mr. Katz:

The Investment Company Institute [1] appreciates the opportunity to express its views on the Securities and Exchange Commission's proposed temporary rule and temporary rule amendment that would require certain transfer agents and broker-dealers, respectively, to file initial and follow-up reports on the status of their preparations for the Year 2000.[2]

Proposed temporary Rule 17Ad-18 under the Securities Exchange Act of 1934 ("Exchange Act") would require all non-bank registered transfer agents that do not qualify for an exemption from the reporting requirements of Rule 17Ad-13 under the Exchange Act to file an initial report and two follow-up reports.[3] A proposed temporary rule amendment to Rule 17a-5 under the Exchange Act would require all registered broker-dealers with a minimum net capital requirement of $100,000 or more to file an initial report and a single follow-up report. The Proposed Rules also would require that each follow-up report include an attestation by an independent public accountant representing its opinion on whether there is a reasonable basis for certain required assertions by management in the reports.

These proposals were developed as part of the Commission's efforts to evaluate the ability of securities industry participants to manage and prevent Year 2000 problems. The Institute supports these efforts; issues related to the Year 2000 should be addressed by all securities industry participants, including the investment management industry, whose continued success is predicated on maintaining investor confidence. In this regard, it is appropriate for the Commission to ascertain the steps being taken by market participants in preparing for the Year 2000. Our comments are intended to maintain a balance between assisting the Commission in achieving its stated goals and supporting our members' efforts to become Year 2000 compliant in a timely manner.

Specifically, and as discussed in more detail below, the Institute recommends that the Commission: (1) delete or modify the proposed independent accountant attestation requirement; (2) provide that the proposed reports will be kept confidential; (3) clarify that firms will not be required to guarantee that their systems are fail-safe; (4) clarify the level of board oversight needed for executing Year 2000 plans; (5) provide guidance on the format of the reports' responses; (6) clarify the level of detail required to be reported regarding tasks and responsibilities of personnel involved in the Year 2000 effort; and (7) provide guidance on certain timing issues.

In addition, as a preliminary matter, the Institute wishes to respond to the Commission's request for comment on whether registered investment advisers and investment companies should be required to file reports regarding Year 2000 compliance.[4] The Institute does not believe that these entities should be subject to such reporting requirements, as they are not necessary to increase awareness of, or monitor progress in resolving, Year 2000 problems. The Commission already has issued a series of notices and letters on the responsibilities of investment advisers and investment companies in this area.[5] The SEC staff also is reviewing Year 2000 disclosures in fund registration statements and has developed a special Year 2000 module for its examinations of investment companies. Moreover, a survey conducted by the Institute last year (at the request of the staff) demonstrated that Year 2000 compliance was a high priority for the fund industry.[6] In light of the foregoing, we would question the need for extending the requirements to investment advisers and investment companies. At the very least, if the Commission ultimately decides to subject investment advisers to Year 2000 reporting requirements, it clearly should continue to exclude registered investment companies.

Because virtually all investment companies are externally managed, requiring them to file these reports would simply be a redundant and unnecessary burden, which would direct valuable resources away from resolving Year 2000 problems.[7]

Auditor's Attestation

The Proposed Rules would require that each follow-up report include an attestation by an independent public accountant representing its opinion on whether there is a reasonable basis for certain required assertions by management. This requirement is problematic for a number of reasons. First, solving the Year 2000 problem is an extensive and technically complex undertaking. To the extent that an independent accountant determines that it must conduct a thorough review of a firm's systems and operations in order to opine on the reasonableness of management's assertions, such a review could be very costly, time-consuming, and operationally disruptive, particularly if it entails reviewing an investment company complex's comprehensive Year 2000 plan.[8]

In addition, the Institute is skeptical that independent accountants have the expertise necessary to perform this type of engagement.[9] The attestation provision presumes an independent accountant will perform appropriate tests to satisfy himself that management's representations on its Year 2000 status are reasonable. Because of the complexity of the Year 2000 problem, it is unclear whether independent accountants have the technical expertise to perform this type of review, particularly since their focus primarily is on financial audits. Moreover, the Proposed Rules require independent accountants to attest to certain actions without providing criteria against which to measure the quality of such actions. For example, although an attestation ostensibly could address whether testing had occurred, without objective standards, it is questionable whether an independent accountant could assess the reasonableness of the testing plan, the accuracy and validity of the test results, or the appropriateness of a firm's modifications in response to such results. Absent these determinations, persons reviewing the reports could misunderstand and misinterpret the independent accountant's attestation.

Finally, even if technical expertise were not an issue, and there were Year 2000 standards available against which a firm's actions could be measured, it remains to be seen whether, collectively, independent accountants have the capacity to perform this type of review considering the timeframe proposed. Under the proposals, all covered transfer agents would have to file each follow-up report at the same time. Similarly, all covered broker-dealers that have the same fiscal yearend would have to file their follow-up report within the same 90-day period. Accordingly, there is serious concern whether there would be sufficient numbers of qualified independent accountants ready, willing, and able to fulfill this requirement.

Based on the foregoing concerns, we strongly recommend that the Commission delete the attestation requirement, or at the very least, modify it to take into account these concerns.

Public Availability of the Reports

As proposed, the initial and follow-up reports on Year 2000 readiness filed with the Commission would be made available to the public. The Commission requested comment on whether these reports should not be publicly available. For the following reasons, the Institute recommends that the reports be treated confidentially.

First, because of the technical nature of the reports' subject matter, investors could misperceive certain information, and draw erroneous conclusions from it, even though the firm could be on schedule with its Year 2000 plan. This is especially likely with respect to the exceptions reporting requirement.

As proposed, covered transfer agents and broker-dealers would be required to report the number and nature of the exceptions resulting from internal and external, or industry-wide systems testing. Systems testing is instrumental in determining areas that need attention and modification, but any report of such testing is merely a temporary "snapshot" of the system's status as of a given point in time. Unless viewed in the proper context, detailed testing reports could be misleading, and potentially and unnecessarily alarming to the reader.[10] In an attempt to avoid possible misunderstandings, certain firms could be somewhat circumspect in their responses, thereby minimizing the value of the information to the Commission.

Second, the proposed reports likely will contain confidential proprietary information. Moreover, the information the Commission is soliciting is designed in large measure to support and supplement the Commission's examination function. Thus, it is more appropriately handled in the same manner as other information that the Commission obtains through its examination program, rather than information it obtains through its typical regulatory filings. Further, we believe the reports appropriately would be treated as nonpublic records under the Freedom of Information Act and regulations thereunder.[11]

Finally, as indicated above, registered investment companies are subject to prospectus disclosure requirements with respect to material Year 2000 issues. Thus, to the extent material issues or problems involving a fund transfer agent or fund underwriter became evident as a result of systems testing (for example), disclosure by the fund likely would be required. Accordingly, in the case of such transfer agents and underwriters, we believe that applicable disclosure requirements appropriately address the public policy

interest of making relevant information available to the public.

Management Assurances

Certain provisions in the Proposed Rules imply that a firm's management should provide assurances that it will be Year 2000 compliant.[12] Because of the complexity of the Year 2000 problem, it may not be possible for a firm, prior to Year 2000, to provide assurances that it will be Year 2000 compliant. Addressing the Year 2000 problem involves a myriad of operational and legal issues that, in the case of an investment company complex, must be resolved within an organizational framework that necessarily includes coordination among a variety of business units and external third-party vendors. While efforts are underway to obtain assurances from third parties upon which fund groups rely, it is possible that, for example, an "external" system could cause a fund transfer agent's "internal" system to fail. Given that possibility, it is virtually impossible to provide any type of guarantee that a firm's internal system will be absolutely fail-safe. While the NASD and other industry participants will be performing critical systems testing, the absence of problems in connection with such tests does not necessarily guarantee that no problems will occur on any part of a critical system or interface when Year 2000 arrives.

Accordingly, the Institute requests that the Commission clarify that firms (and, if the attestation requirements is not deleted, independent accountants) are not required to guarantee or provide other assurances or certifications that their systems or interfaces (or contingency plans with respect to such systems or interfaces) will not fail. For example, the Commission should revise the proposals so as to solicit assurances that a firm has reasonable policies and procedures in place to address known and reasonably anticipated Year 2000 problems and to become Year 2000 compliant, as necessary.[13] To the extent the Commission retains the proposed attestation requirement discussed above, a change along these lines likely would more appropriately define the scope of the attestation—although it still would not address concerns about the accountant's technical expertise or capacity.

Board Oversight

The Proposed Rules would require transfer agents and broker-dealers to provide information concerning responsibility for Year 2000 compliance. The Institute recommends the following modifications in this area. First, the Institute notes that the attestation provision requires an independent accountant to attest that a member of a firm's board of directors (or similar body) is responsible for the execution of the firm's Year 2000 plan. This responsibility, however, is not required in the reporting section of the Proposed Rules—nor is it discussed anywhere else in the releases. We do not believe that execution of the plan, in most circumstances, would be an appropriate function for a firm's board of directors. Rather, firm management (i.e., senior officers) typically is responsible for executing company policies and procedures. As such, a firm's officers typically would be responsible for executing the Year 2000 plan and preparing and providing periodic progress reports to the board as appropriate. We recommend that the Commission clarify that, subject to board oversight, execution of Year 2000 plans may be delegated to a senior officer of the firm.

In addition, certain provisions of the Proposed Rules inquire whether a firm's board of directors (or similar body) has approved its Year 2000 plan. The Institute notes that some fund transfer agents and fund underwriters do not have their own separate board of directors, but rather are managed by the investment adviser's board or senior management. We suggest, therefore, that the Commission clarify that the Proposed Rules contemplate these types of organizational structures.

Report Format

The Proposed Rules do not provide a format for responses. Thus, while one firm could file a detailed report that contains lengthy explanations, another firm could file a report that is much more succinct. Given the industry's concern for becoming Year 2000 compliant, yet satisfying the Commission's goals for ascertaining Year 2000 readiness, the Institute requests that the Commission provide guidance in this area that would provide for some level of uniformity while enabling firms to complete the reports in a timely and more cost-effective manner.[14]

In a related matter, the Proposed Rules would require each report to discuss "any additional material information ... that will help the Commission assess the [firm's] readiness for the Year 2000."[15] This provision is troubling because it is so open-ended. We recommend that the Commission either clarify what it has in mind (e.g., by providing examples) or delete the provision.

Task and Responsibility Reporting

As proposed, each covered transfer agent and broker-dealer would be required to discuss the extent to which it has assigned existing employees, hired new employees, or engaged third parties to assist in the Year 2000 effort, and the work that these individuals have performed as of the date of each report. Each firm must also identify the levels of management involved, describe their responsibilities, and document an estimate of the percentage of time each person has spent on Year 2000 issues during the preceding twelve-month period.[16]

These requirements are potentially very burdensome, particularly for those firms that have comprehensive, complex-wide Year 2000 plans. Resolving the Year 2000 problem requires the dedicated efforts of large numbers of employees and, in most cases, outside consultants. The myriad of tasks and responsibilities involved not only are detailed and extensive, but also are constantly changing as new issues arise. It would be neither feasible nor productive to document, aggregate, and summarize this information for (in some cases) upwards of one hundred employees and consultants involved in addressing Year 2000 issues. Moreover, doing so could be disruptive to the firm's operations and potentially could hamper its efforts in effectively resolving ongoing Year 2000 issues. Instead, the Institute recommends that firms be required to provide a summary description of the work involved and the name of the person assigned primary responsibility for completing it. This approach likely would provide the Commission with a more manageable amount of information in a more comprehensible format.[17]

Timing Issues

The proposing releases state that the Proposed Rules would require the initial report to be filed no later than 45 days after adoption of the rules and require the covered transfer agent or broker-dealer to evaluate its actions as of December 31, 1997. The actual text of each rule, however, is silent on the period that the initial report would have to cover. The Institute is concerned that firms may not be able to re-create and report their status as of December 31, 1997. Since no reporting requirements were imposed at that time, in many cases that information simply may not be available. More importantly, even if firms could recover the information, it would be stale and have limited, if any, use or relevance. Instead, we recommend that the Commission clarify that the initial report should be as of a date more recent in relation to the deadline for filing the report.[18]

Finally, the Institute notes that, as proposed, a covered transfer agent's second report would be due on August 31, 1998, and would reflect information as of June 30, 1998. Given our suggestion above that the initial report (which would be due within 45 days after the Proposed Rules are adopted) contain information as of a date reasonably close to the time of filing, the Institute recommends that the Commission modify the deadline for filing the second report to a date that would provide for more even spacing between the initial and second report filing dates.[19]

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The Institute appreciates the opportunity to comment on these releases. Any questions may be directed to the undersigned at (202) 326-5923 or to Frances Stadler at (202) 326-5822.

Sincerely,

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ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,987 open-end investment companies ("mutual funds"), 437 closed-end investment companies, and 9 sponsors of unit investment trusts. Its mutual fund members have assets of about $4.747 trillion, accounting for approximately 95% of total industry assets, and have over 62 million individual shareholders. Many of the Institute's investment adviser members render investment advice to both investment companies and other clients. In addition, the Institute's membership includes 488 associate members which render investment management services exclusively to noninvestment company clients. A substantial portion of the total assets managed by registered investment advisers are managed by these Institute members and associate members.

[2] SEC Release No. No. 34-39726; File No. S7-8-98 (March 5, 1998) ("Transfer Agent Release"); SEC Release Nos. 34-39724, IC-23059, IA-1704; File No. S7-7-98 (March 5, 1998) ("Broker-Dealer Release") (collectively, the "Proposed Rules").

[3] As proposed, the temporary rule would exclude non-bank transfer agents that are (1) small transfer agents or (2) issuer transfer agents from filing follow-up reports.

[4] See Broker-Dealer Release at 13.

[5] See, e.g., Revised Staff Legal Bulletin No. 5 (CF/IM) (Jan. 12, 1998); Year 2000 Letter to Investment Advisers, from Arthur Levitt, Chairman, SEC (Nov. 7, 1997); Testimony of Brian Lane, Director, Division of Corporation Finance, SEC, before the Subcommittee on Financial Services and Technology Committee on Banking, Housing, and Urban Affairs (Oct. 22, 1997); and Staff Legal Bulletin No. 5 (CF/IM) (Oct. 8, 1997).

[6] The results of the survey, which represented 70% of industry assets, indicated that boards of directors and senior officers were assessing the impact of the Year 2000 problem on investment company complex operations and were taking appropriate steps to implement plans and devote adequate resources to address the problem. (The Institute is in the process of conducting a follow-up survey on Year 2000 preparedness.)

[7] The Institute notes that fund transfer agents and fund underwriters likewise seem to be fully aware of the need to institute a rigorous Year 2000 compliance program. The Commission already has communicated its concerns in letters to both broker-dealers and transfer agents. See Year 2000 Letter to Transfer Agents, from Arthur Levitt, Chairman, SEC (Oct. 22, 1997), and Year 2000 Letter to Broker-Dealers, from Arthur Levitt, Chairman, SEC (Oct. 27, 1997). The NASD also has been active in this regard, by issuing a survey and special notice and establishing test centers. See Special NASD Notice to Members 97-96 and NASD Regulation Inc. - Required Member Survey Year 2000 Compliance (Dec. 1997); and NASD Notice to Members 98-22 - Year 2000 Frequently Asked Questions (Feb. 1998). As mentioned in these notices, the securities industry, coordinated by the Securities Industry Association, is planning for industry-wide testing from August 1998 to December 1999. In light of the foregoing, even if the Commission is not inclined to accept our recommendations with respect to transfer agents and broker-dealers generally, it should consider implementing our suggestions with respect to mutual fund transfer agents and underwriters.

[8] The attestation provisions require the independent accountant to attest that the firm's Year 2000 plan addresses, among other things, the activities of each of its subsidiaries, affiliates, and divisions (unless they are regulated by U.S. or foreign regulators other than the SEC). Thus, to the extent the independent accountant's review extends to these entities, the overall time and cost involved could increase substantially. In addition, as drafted, this provision would encompass certain entities that are regulated by the SEC but not presently covered by the Proposed Rules, such as investment advisers and investment companies that are affiliated with a transfer agent or broker-dealer. Accordingly, the Institute is concerned that this provision could require firms to incur attestation costs for such entities that would not otherwise be subject to the Proposed Rules. This result would seem to require indirectly what we recommend against requiring directly (i.e., application of the proposals to investment advisers and investment companies).

[9] We also understand that because of liability concerns, independent accountants may be disinclined to perform this type of review or issue an opinion related to it. Further, we are concerned that independent accountants' professional fees for this type of engagement may be significantly greater than the Commission's estimates due to these liability concerns. For those firms that would need to engage special management information systems accountants because their existing accountants lack the necessary expertise, to the extent such accountants are unfamiliar with the firm's operations or systems, obtaining the attestation, particularly within the proposed timeframe provided, could be more difficult, more time-consuming, and, hence, more costly.

[10] It would not be uncommon, for example, for a firm to correct its deficiencies resulting from a given test soon after filing the report.

[11] See, e.g., 5 U.S.C. § 552(b)(8) and 17 CFR § 200.80(b)(8) (providing for nonpublic treatment of matters that are "[c]ontained in, or related to, any examination, operating, or condition report prepared by, on behalf of, or for the use of, the Commission ...."). See also 5 U.S.C. § 552 (b)(4) and 17 CFR § 200.80(b)(4)(iii) (providing for nonpublic treatment of "trade secrets and commercial or financial information obtained from a person and privileged or confidential, including ... [i]nformation contained in reports ... arising out of or in connection with an examination or inspection of the books and records of any person or any other investigation.").

[12] For example, footnotes 11 and 7 to the Transfer Agent Release and Broker-Dealer Release, respectively, require contingency plans to provide for adequate protections "to ensure the success of critical systems if interfaces fail or unexpected problems are experienced with operating systems and infrastructure software." (Emphasis added.) In addition, the attestation provisions for both proposals require an independent accountant to attest to management's determination that "as a result of the internal, external, or industry-wide testing it has modified its software to correct Year 2000 Problems." (Emphasis added.)

[13] Similarly, because it may not be realistic to expect a firm to avoid all Year 2000 problems, we suggest that the word "avoid" be replaced with the word "address" throughout the releases.

[14] One possible alternative to having firms prepare lengthy and detailed reports would be to have the Commission prepare a form of "short answer" questionnaire. This would be beneficial to both the Commission and the industry. The Commission would benefit because it would create a uniform format of responses that would make it easier to synthesize aggregate information; the industry would benefit because it would eliminate some of the uncertainty as to the scope of the report.

[15] See p. 22, Transfer Agent Release and Broker-Dealer Release, respectively.

[16] We note that it may not be possible, at least in the initial report, to provide information about the percentage of time that each individual member of a firm's management has spent on Year 2000 issues during the preceding twelve-month period, as such persons may not have been keeping track of this information. In any event, the information would seem to have limited relevance or usefulness. We recommend that the Commission eliminate this requirement.

[17] The Commission's guidance on the formatting issue, as recommended above, could help address these concerns.

[18] For example, the Proposed Rules could require that the reports be as of the most recent date practicable in relation to the date of filing.

[19] The Institute notes that because December 1998 is an important month for many companies, as they attempt to finalize their modifications in preparation for systems testing in 1999, one possibility would be to make the second report due during the first quarter of 1999, for the period ended December 31, 1998. This arrangement also would allow for better spacing between the second and third report filing dates, which presently is proposed to be one year.

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