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December 7, 2000

BY MESSENGER

Robert E. Plaze
Associate Director
Office of the Associate
Director(Regulation)
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Review of Rule 17f-4

Dear Mr. Plaze:

I am writing on behalf of the Association of Global Custodians ("Association") in response to my conversations, earlier this year, with Jaea Hahn and Martha Peterson of your staff.[1] Ms. Hahn and Ms. Peterson invited the Association to submit in writing any suggestions we might have concerning possible revisions to Investment Company Act Rule 17f-4 in order that these could be taken into account during the staff's review

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1/ As noted in our prior submissions to the Commission, the Association is an informal coalition of nine U.S. banks that act, directly or through affiliates, as global custodians or sub-custodians for the assets of major institutional investors, including registered investment companies. The members of the Association are The Bank of New York, Bankers Trust Company/Deutsche Bank, Brown Brothers Harriman, The Chase Manhattan Bank, Citibank, N.A., Investors Bank & Trust Company, Mellon Trust/Boston Safe Deposit & Trust Company, Northern Trust Company, and State Street Bank and Trust Company.

of the rule.[2] The Association appreciates this request and apologizes for its delay in responding.

Overview

As cross-border depository linkages become more common, the line between national and transnational depositories is becoming blurred. With increasing frequency, depositories that have been thought of as local facilities serving a single market are becoming access points for clearance, settlement, and custody of securities held outside the boundaries of the country in which the depository operates. Conversely, transnational depositories, which have traditionally provided custody and clearing for stateless securities, are becoming, in effect, wholesale global custody facilities through which securities that trade in the local markets of many jurisdictions are immobilized.

2/ The Commission has indicated publicly that Rule 17f-4 is under review. The Commission's most recent Regulatory Flexibility Act agenda contains the following item:

> "The staff of the Division of Investment Management is considering whether to recommend that the Commission propose amendments to Rule 17f-4, which governs the use of securities depositories as to custodians of the assets of management investment companies. The amendments would, among other things, update and simplify the rule's compliance requirements to reflect changes in commercial law, expand the types of entities that may be used as securities depositories, and permit investment company officers to authorize depository arrangements." Securities Act Release No. 7911 (October 17, 2000).

This statement suggests that the staff's proposed review of Rule 17f-4 does not encompass issues relating to the use of U.S. depositories as cross-border clearance and custody facilities. As discussed in this letter, we urge that such issues be included in any review of Rule 17f-4.

These changes in the nature and functions of depositories have important ramifications for investment companies that utilize the services of depositories. We urge that, in reviewing its regulation of investment company use of "domestic" depositories under Rule 17f-4, the Commission recognize that sharp distinctions between domestic and transnational depositories may no longer be possible. Questions that should be addressed include, for example --

- When a U.S. depository is a part of the chain of custody for investment company assets that are held outside of the United States, how do Rules 17f-5 and 17f-7 apply to the foreign banks and depositories to which the U.S. depository is linked? For the Commission, in essence, to waive compliance with Rules 17f-5 and 17f-7 simply because a U.S. depository has been interposed in the chain of custody would seem to be contrary to the investor protection principles that underpin those rules.

- What disclosures should be made to U.S. investment companies and their shareholders when fund assets are held offshore through the fund's use of a U.S. depository? An investment company may hold, through an account at a U.S. depository, a U.S.-traded security of a foreign issuer. If, as is often the case, the primary trading market for the security is outside of the United States, the account at the U.S. depository may simply represent shares that are, in fact, held off-shore. However, the fact that assets are held offshore is seldom evident to the fund and its shareholders.

- What are the respective responsibilities and liabilities of the various participants in investment company foreign custody when a U.S. depository is involved? Rules 17f-5 and Rule 17f-7 establish standards under which investment companies may place assets with foreign institutions. Those rules do not at present contemplate the use of a U.S. depository as a link in a chain of custody that ends in a foreign market.

In its recent adoption of Rule 17f-7, the Commission made clear that a fund's board of directors must receive information

concerning the foreign depositories through which the fund holds securities. Receipt of an assessment of depository risk permits the fund to include an evaluation of the depository as part of its decision-making concerning foreign investment. We believe that, when a U.S. depository provides foreign custody services, the same principle should apply. The U.S. depository should be required to disclose information concerning the entities through which it provides foreign custody. This, in turn will permit U.S. funds, and other types of investors, that use the facilities of the depository to hold assets offshore to understand the foreign custody relationships through their assets are held and to include foreign custody considerations in their investment decision-making.

Background -- Rule 17f-4, Rule 17f-5, and Rule 17f-7

Rule 17f-4 governs custody of investment company assets by domestic clearing agencies that act as securities depositories and are registered with the Commission under Section 17A of the Securities Exchange Act. The Depository Trust Company ("DTC") is one such entity. In general terms, Rule 17f-4 permits an investment company to place its assets in the custody of a registered clearing agency either directly or through the fund's custodian. When assets are placed in a Rule 17f-4 depository through a custodian, the assets must be subject to an "arrangement" that includes certain features set forth in the rule.[3]

3/ These features include:

(1) The custodian must deposit the assets directly or "through one or more agents which are also qualified to act as custodians for investment companies."

(2) The custodian's (or agent's) account at the depository must "includ[e] only assets held by it for customers."

(3) The custodian must send the investment company a confirmation (i.e., an "advice or notice of the

In contrast, Rule 17f-5 and Rule 17f-7 govern foreign custody of investment company assets by entities that are not subject to registration with the Commission under Section 17A or otherwise. Rule 17f-5 permits an investment company to maintain assets outside of the United States in the custody of a foreign bank. In general terms, Rule 17f-5 requires that --

- the foreign custodian must satisfy the definition of the term Eligible Foreign Custodian,
- the fund's Foreign Custody Manager must find that the assets will be subject to reasonable care in the hands of the foreign custodian,[4] and
- the custody arrangement must be governed by a written contract.

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transaction") with respect to any transfers to or from the account of the investment company.

(4) When securities are transferred to the depository account, "the custodian shall also, by book-entry or otherwise, identify as belonging to the investment company a quantity of securities in a fungible bulk of securities (i) registered in the name of the custodian (or its nominee) or (ii) shown on the custodian's account on the books of the clearing agency, the book-entry system, or the custodian's agent."

(5) The custodian (or its agent) must promptly send to the investment company any reports it receives on the depository's system of internal accounting control.

4/ Reasonable care is determined relative to practices in the local market. Rule 17f-5(c) lists factors that should be considered in making this determination.

Rule 17f-7 addresses the custody of investment company assets by foreign securities depositories. Rule 17f-7 essentially contains two requirements. First, the foreign securities depository must meet certain eligibility standards.[5] Second, the custody arrangement under which the fund's assets are held must provide "reasonable safeguards" against the custody risks associated with maintaining assets with the depository. These safeguards must include a contractual obligation on the part of the fund's Primary Custodian to provide the fund with an analysis of the custody risk associated with maintaining assets at the foreign depository and to monitor the depository for changes in its risk profile.

Cross-Border Depository Linkages

The regulatory regime created by Rules 17f-4, 17f-5, and 17f-7 is implicitly premised on two assumptions -- that U.S. depositories will handle and hold securities that are traded in the United States, and that foreign banks and depositories will handle and hold securities that trade outside the United States, in the markets of the jurisdiction in which they are located. However, as noted above, these assumptions are becoming obsolete.

Cross-border linkages and mergers between depositories and clearing systems are now commonplace. For example, Euroclear has recently merged with Sicovam, the clearing and depository facilitity for the Paris Bourse. Euroclear is reportedly also in negotiations with the Dutch and Belgian depositories. Euroclear has indicated that it envisions a worldwide "hub and spoke" structure under which it would be the "hub" through which securities transactions could be cleared, and securities held, in many markets by means of Euroclear's links with local central securities depositories. Clearstream, another transnational depository, was recently formed by the merger of Cedel and Deutsche Borse Clearing. Clearstream, which is also seeking to transform itself into a single entry point for many markets, has in turn entered into an alliance with Crest, the United Kingdom's clearing facility.

5/ See Rule 17f-7(b)(1).

This trend has not stopped at the borders of the United States. DTC has also begun to establish linkages with foreign securities depositories.[6] As a result, it is already possible for a U.S. institutional investor to hold, through an account with DTC, securities that are recorded on the books of a depository in Canada or Germany. Those securities may, in turn, ultimately be held in a depository in yet another jurisdiction.

In short, the function and geographical reach of traditional depositories are rapidly changing. Local depositories are no longer merely utilities that serve a single market. They are instead portals to custody in many markets. As a result, it is becoming possible for an investor to hold securities that trade in a foreign market through an account at the central securities depository that serves the stock exchange in the investor's local market.

Impact of Cross-Border Linkages on the Review of Rule 17f-4

Because of the ability to hold securities that trade in a foreign securities market through an account at a domestic depository, a critical element of any review of Rule 17f-4 should be an examination of the foreign custody relationships that can arise through the use of U.S. domestic depositories. Some of the issues raised by the transformation of depositories from local to transnational are listed below.

A. What is the Proper Relationship Between Rules 17f-4, 17f-5, and 17f-7?

The ability to hold offshore securities positions through a domestic depository raises questions concerning the relationship between Rule 17f-4 and cross-border custody under Rules 17f-5 and 17f-7. In its January 10, 2000 supplemental comment letter on

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6/ See, e.g., Securities Exchange Act Release No. 40660 (November 10, 1998) (Commission approval of "enhanced" link between DTC and Deutsche Börse Clearing AG); Securities Exchange Act Release No. 40523 (October 6, 1998) (Commission approval of "enhanced" link between DTC and the Canadian Depository for Securities Ltd.).

issue.[7] The Association urged that, when a U.S. depository provides cross-border services, the depository's subcustodians (i.e., any foreign banks with which it maintains custody accounts) should be subject to Rule 17f-5, like any other subcustodians. Accordingly, such a U.S. depository should be required to provide representations concerning the Rule 17f-5 compliance of its "network." We do not believe that it would be realistic to expect the Fund's Foreign Custody Manager to assume responsibility for evaluating and monitoring the subcustodians selected by a U.S. depository.[8]

Similarly, foreign depositories to which a U.S. depository provides direct links should be subject to the eligibility requirements in Rule 17f-7. The U.S. depository should be expected to cooperate in the collection of risk assessment information concerning such foreign depositories so that the fund board can consider this information as part of its investment decision-making.[9]

7/ See Letter, dated January 10, 2000, from Daniel L. Goelzer, to Thomas M.J. Kerwin, Senior Counsel, Office of Regulatory Policy, Division of Investment Management, Re: File No. S7-15-99 -- Custody of Investment Company Assets Outside the United States/Investment Company Act Release No. 23815 (April 29, 1999), at 6-7.

8/ Under Rule 17f-5, the Foreign Custody Manager must find that assets held with foreign subcustodians are subject to reasonable care and held pursuant to appropriate contractual protections and must monitor the fund's subcustody relationships. However, where a fund's use of foreign subcustodians results from a U.S. depository's foreign custody relationships, the Foreign Custody manager obviously has no control over or information concerning the subcustodians. In this situation, the Foreign Custody Manager cannot be expected to select, evaluate, contract with, and monitor these institutions.

9/ As set forth in the Association's comments on proposed Rule 17f-7, we also believe that non-U.S. transnational depositories, such as Euroclear and Clearstream, should be subject to these same obligations. Id. at 8.

The Association adheres to the views in its January 10 letter. If a domestic depository steps out of its role as a central securities depository for securities that trade in the United States by offering to provide cross-border global custody services, that depository's compliance with Rule 17f-4 should not supercede the application of Rules 17f-5 and 17f-7 to the foreign institutions through which the U.S. depository provides cross-border custody to U.S. investment companies.

If the opposite view were taken -- that is, if Rule 17f-4 compliance were treated as obviating the need to apply Rules 17f-5 and 17f-7 to the foreign banks and depositories utilized by the U.S. depository -- such a view would be inconsistent with the investor protection objectives of Section 17(f) of the Act. Indeed, Rules 17f-5 and 17f-7 could become dead letters, since compliance would become optional. These rules, which have recently been the subject of extensive Commission consideration, contain important investor protections and should not be bypassed merely through the use of a U.S. depository as the access point to foreign markets.[10]

B. What are the Disclosure Consequences of the Transformation of Depositories From National to Transnational Facilities?

Another issue that, we believe, must be confronted is whether SEC-registered clearing agencies that perform depository functions should be required to disclose the extent to which registered investment company assets held through the depository's facilities are in foreign custody. As noted above, the increasing incidence of securities admitted to trading in numerous markets means that an investor may purchase a foreign security in the investor's home market and hold that security through an account at the local depository. The investor's local

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10/ In addition, competitive imbalances would result. Funds that hold assets through accounts with a U.S. depository would be relieved of the costs of compliance with Rules 17f-5 and 17f-7, while those that utilize the services of a global custodian bank that maintains its own subcustody network would be required to bear these costs. There would be no logical justification for this difference in treatment.

depository may, however, merely have a position in the security in question on the books of the central securities depository in the jurisdiction in which the primary trading market for that security is located. In effect, the investor's security, although purchased in the investor's local market, is in foreign custody, just as it would be if the investor had made his purchase in the primary market.

When an investor purchases a security in its local trading market, the fact that the security may be held in foreign custody is seldom evident. The Association believes that the Commission should consider the need to require U.S. depositories to disclose the custody risks associated with maintaining assets overseas so that fund boards can evaluate them.

C. Should Transnational Depositories Be Subject to Different Regulatory Standards Than Local Market Depositories?

At present, Rule 17f-4 does not impose any standard of care on domestic depositories with respect to assets held for participants overseas. In contrast, Rules 17f-5 and 17f-7 impose detailed and substantial obligations on Foreign Custody Managers and Primary Custodians. Under Rule 17f-5, a Foreign Custody Manager must find that assets held with subcustodians it has selected are subject to reasonable care. A Foreign Custody Manager must assure that assets it has placed with foreign subcustodians are held pursuant to appropriate contractual protections and must monitor its subcustody relationships. If the Foreign Custody Manager is a delegate of the fund's board, it must agree to exercise reasonable care, prudence and diligence, or to adhere to a higher standard of care, in performing these tasks. Similarly, under Rule 17f-7, the fund's Primary Custodian must agree to exercise reasonable care, prudence and diligence, or to adhere to a higher standard of care, in performing its responsibilities, such as preparing risk analyzes of the foreign depositories.

Rule 17f-4 depositories are not subject to any of these obligations. They may, however, perform the same functions as Foreign Custody Managers and Primary Custodians in that they may place and maintain investment company assets with foreign institutions, including other securities depositories. Logic

would seem to dictate that Rule 17f-4 depositories be held to the same standard of care with respect to fund foreign custody. In some cases, fund assets may be held through a chain of custody that includes a U.S. global custodian, a U.S. depository, a foreign subcustodian and a foreign securities depository. The Commission should address the respective responsibilities and obligations of the U.S. depository, and of the fund's board of directors, Foreign Custody Manager, and Primary Custodian, in this situation.

Conclusion

In the Association's view, it is critical that the Commission, in its review of Rule 17f-4, explore the implications of globalization of the securities markets and the resulting impact on depositories registered under Section 17A of the Securities Exchange Act of 1934. If Rule 17f-4 is viewed solely as addressing U.S. institutions that offer domestic depository services in the U.S. securities markets, the result is likely to be confusion and uncertainty. Investor protection is also likely to be compromised, to the extent that registered funds are able to hold assets outside the United States while bypassing the Commission's foreign custody rules.

As noted at the outset of this letter, we believe that disclosure is one of the ways in which these issues should be addressed. When a U.S. depository provides foreign custody services for fund assets, the U.S. depository should be required to disclose information concerning the offshore entities through which it provides foreign custody. This, in turn will permit U.S. funds, and other types of investors, that use the facilities of the depository to understand the foreign custody relationships through which their assets are held and to include foreign custody considerations in their investment decision-making.

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The Association appreciates the opportunity to express its views on this important topic. We would like to meet with you and your staff to discuss our concerns in greater detail and to

offer concrete suggestions for revisions to Rule 17f-4. If you have questions, or to arrange such a meeting, please contact me at 202/452-7013.

In response to the invitation in Securities Act Release No. 7911 (October 17, 2000) for comments on the Commission's Regulatory Flexibility Agenda, we are sending a copy of this letter to the Commission's Secretary for inclusion in File No. S7-19-00.

Sincerely,

Daniel L. Goelzer

cc: Jaea Hahn
Martha Peterson
Division of Investment Management

Jonathan G. Katz
Secretary

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