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BY MESSENGER

C. Hunter Jones
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Office of Regulatory Policy
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0506

Re: Rule 17f-4 Review/Information Regarding Rule 17f-7 Compliance Costs

Dear Mr. Jones:

During our telephone conversation on October 4, 2001, you indicated that the Commission had invited the Association of Global Custodians ("Association") to submit to the staff certain economic information for inclusion in a proposed release concerning amendments to Investment Company Act Rule 17f-4. Based on the discussion during the Commission's October 3, 2001 public meeting, we understand that the Commission is seeking information concerning industry costs of compliance with Rule 17f-7 to aid it in determining whether "a foreign global network [can] compete effectively with a U.S.-based network that has foreign links." (Remarks of Chairman Pitt)

The Association appreciates the opportunity to provide the Commission with this type of economic information. As set forth below, we also suggest that, in order to obtain meaningful comment on this data, the proposed release should include certain other information concerning the Commission's processes for the approval of depository linkages. Finally, we have attached to this letter a chart comparing foreign custody of investment company assets through a depository link with foreign custody through a subcustody arrangement.

Background

On December 7, 2000, the Association submitted a letter to the staff of the Division of Investment Management ("Division") concerning the previously announced

review of Rule 17f-4. In that letter, we recommended that, in reviewing Rule 17f-4, the Commission explore the ramifications of linkages between foreign depositories and domestic depositories registered under Section 17A of the Securities Exchange Act of 1934. The Association pointed specifically to the ability of a registered investment company to use a domestic securities depository that has a link to a foreign securities depository as a means to hold the fund's foreign securities that are in the custody of a foreign depository. As we stated in our December 7 letter, for the Commission, in essence, to waive compliance with Investment Company Act Rules 17f-5 and 17f-7 simply because a U.S. depository has been interposed in the investment company's chain of custody seems contrary to the investor protection principles that underpin those rules. It would also subject funds that hold assets in a foreign depository through traditional global custodian/subcustodian relationships to additional burdens and costs, relative to those funds that access the same depository through a link with a U.S. depository, for no apparent regulatory reason.

At its public meeting on October 3, the Commission considered the Division's recommendation that it publish for comment proposed amendments to Rule 17f-4. During the ensuing discussion, the Division, joined by the Division of Market Regulation, took the position that investor protection does not require compliance with Rule 17f-7 in cases where an investment company uses a domestic depository's linkage with a foreign depository to hold custody of foreign securities. The staff based its view on the assertion that the Division of Market Regulation only permits a domestic depository to link with a foreign depository if the staff determines that the foreign depository will afford protections to assets held through the link that are comparable to those afforded to assets held in domestic depositories. This process was characterized as "exporting U.S. law" to the foreign depository. As a corollary, the staff stated that requiring domestic depositories to comply with Rule 17f-7 would impose an unnecessary cost, since investment company securities held through an SEC-approved depository linkage are not subject to the same foreign custody risks as those on which that rule focuses.

In order that these issues could be explored during the comment process, the Commission directed the staff to afford the Association the opportunity to provide economic information concerning the industry costs of Rule 17f-7 compliance for inclusion in the proposed release.

Economic Information

Based on our telephone conversation last week, I asked the nine Association member banks to provide information concerning their costs to gather information and prepare the required risk analyses under Rule 17f-7. As you are aware, if any of the

assets of a registered investment company are held by a foreign securities depository, Rule 17f-7 requires, among other things, that the fund receive from its global custodian "an analysis of the custody risks associated with maintaining assets" with the depository. In addition, Rule 17f-7 requires that the primary custodian monitor these custody risks "on a continuing basis, and promptly notify the Fund or its investment adviser of any material change in these risks." Accordingly, I asked the member banks to provide the requested information both with respect to the initial analysis of a foreign securities depository and with respect to the required annual monitoring.

Based on the information the banks were able to develop in the short time available, we believe that the aggregate costs of Association members for initial or first-year compliance with Rule 17f-7 were approximately $3.6 million or $400,000 per bank. Not all global custodians that must provide Rule 17f-7 information to registered investment companies are members of the Association, and total industry costs would therefore be higher. Because Rule 17f-7 only became fully effective on July 2, 2001, the industry has limited experience with ongoing monitoring costs. The Association estimates, however, that such costs will be in the range of $2.7 million for Association members or $300,000 per bank.[1]

These figures do not include the costs incurred by investment company directors or adviser personnel in reviewing Rule 17f-7 information concerning foreign securities depositories. In adopting Rule 17f-7, the Commission expressly contemplated that funds would consider Rule 17f-7 risk analysis information as part of their evaluation of "country risk" – the risk associated with investing in securities that will be held in a particular country.[2] While the members of the Association believe, based on their experience, that fund directors and investment advisors take this responsibility seriously, we are not able to estimate the costs of this activity. The Association does, however, believe that the costs of Rule 17f-7 compliance, including both those incurred

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1/ These figures were derived by combining and averaging cost estimates from various member banks. The members of the Association regard their regulatory compliance cost as proprietary, and the averages do not reflect the actual costs of any specific member bank.

2/ The Commission stated that its purpose was to require that funds and their advisers "be fully apprised" of the risks associated with the use of the local depository "when they make the decision to invest in the country on an ongoing basis." Investment Company Act Release No. 24424, 65 Fed. Reg. 86, 25630 at 25633 (April 27, 2000). See also Investment Company Act Release No. 23815, 64 Fed. Reg. 87, 24489 at 24490-91 (April 29, 1999).

by global custodians and those incurred by investment companies, are reasonable, relative to the objective of permitting funds to weigh depository risk as part of their foreign investment decision-making.

You also asked that we distinguish, if possible, between costs associated with developed markets and those associated with emerging markets. Most banks do not track compliance costs on this basis. The member banks believe, however, that Rule 17f-7 costs do not vary greatly depending on the sophistication of the market. For the members of the Association -- major global custodian banks that offer custody services in many markets around the world -- a large fraction of the cost of Rule 17f-7 compliance is fixed. That is, these banks have developed systems and procedures for gathering risk-related information concerning depositories and have hired and trained personnel that specialize in such work. Therefore, the marginal cost of adding an additional depository to the list of facilities concerning which the bank provides risk analysis information to its investment company clients is not large. Conversely, the cost of creating and maintaining the capability to comply with Rule 17f-7 is significant.

Impact on the Release

We appreciate the Commission's willingness to include this type of economic information in the proposed release. The Association would respectfully suggest that, in order to obtain meaningful comment, the release should also discuss, and solicit comment on, several issues that the staff, not the Association, is in a position to provide. These items are listed below.

- The release should include a discussion of the type of review performed by the Division of Market Regulation on foreign depositories with which a domestic depository seeks to link. As noted earlier, the staff referred to this process during the October 3 open meeting as "exporting U.S. law." However, we are not aware of any publicly available Commission statement describing the scope and nature of this review or the standards that the staff applies in determining that a foreign depository is as safe as a registered domestic depository. Because of the responsibility imposed under Rule 17f-7 to gather information concerning depository risk, and because of the suggestion that the Commission's approval obviates the need for Rule 17f-7 compliance, we believe there would be great public interest in the staff's practices in this regard.

- Similarly, the release should include a discussion of the scope and nature of the review that the staff expects a U.S. depository to perform, and the

standards that the staff expects a U.S. depository to apply, in determining whether to request Commission approval of a link with that depository.[3] In order to afford a basis for comparison with Rule 17f-7 compliance costs, the costs associated with the due diligence review should also be set forth in the release.

- As noted above, Rule 17f-7 requires that custody arrangements be monitored, and that the appropriateness of maintaining the arrangements be continuously reviewed. Therefore, the nature and cost of any comparable monitoring performed by the Commission's staff, or by the domestic

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3/ In general, Commission notices and orders regarding cross-border depository linkages are silent on this issue. However, the notice of the proposed linkage between the Depository Trust Company ("DTC") and SIS SegaIntersettle AG ("SIS") contains the following:

> "In establishing an account at a foreign depository such as SIS, DTC performs risk analysis of the foreign depository to assess whether, in the aggregate, the foreign depository has what DTC determines to be an acceptable risk profile. DTC's risk analysis includes, among other things, an evaluation of the foreign depository in the areas of operational control, financial strength, technological capabilities, market reputation and standing, contract and legal protection, regulation, audit arrangements, and subcustody usage." Securities Exchange Act Release No. 42482, 65 Fed. Reg. 47, 12602 at n. 4 (March 1, 2000). See also Securities Exchange Act Release No. 42782, 65 Fed. Reg. 98, 31952 (May 15, 2000)(DTC/SIS linkage approval order).

The statement that DTC assesses whether the foreign depository "has what DTC determines to be an acceptable risk profile" is a truism. It sheds little or no light on the substantive standards DTC applies or how those standards might relate to risk analysis under Rule 17f-7. A description of what DTC views as "an acceptable risk profile," along with an explanation of the practices and methods by which it is determined whether a foreign depository fits this profile, would be helpful in developing a meaningful comparison to Rule 17f-7.

depository, should be described in the release in order to afford a basis for comparison with the costs of Rule 17f-7 compliance. [4]

- During the October 3 open meeting, the staff suggested that linkages may involve terms and conditions that have the effect of affording special protections to assets held through the linkage and that are not applicable to fund assets held through an account with a subcustodian that is a participant in the foreign depository. Any such terms and conditions should be described in the release. Because of the obligation Rule 17f-7 imposes on global custodians to inform investment company boards concerning depository risk, it is important to understand the conditions that the staff has found necessary or appropriate to reduce such risk. Further, Rule 17f-7(b)(1)(iii) provides that, in order to be eligible to hold investment company securities under Rule 17f-7, a foreign depository must "[h]old assets for the custodian that participates in the system on behalf of the Fund under safekeeping conditions no less favorable than the conditions that apply to other participants." If a foreign depository has, as a condition of linking with a U.S. depository, agreed to afford special protections to assets held through the link, questions would arise concerning whether the foreign depository is in violation of Rule 17f-7(b)(1)(iii), the "equal treatment" requirement.

Regulatory Framework

The Association believes it is clear that the role of domestic depositories is rapidly changing from single-market utilities to access points to custody facilities, including foreign depositories, in many jurisdictions.[5] Therefore, while the Association

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4/ As in the case of the U.S. depository's initial review, monitoring practices are generally not discussed in Commission notices and orders regarding cross-border depository linkages. However, the notice of the proposed DTC/SIS linkage states:

> "Once an account is established, DTC conducts ongoing monitoring of material events and periodic risk assessments evaluating the same areas as when the account was being established." Securities Exchange Act Release No. 42482, supra.

5/ Indeed, the Commission recently issued an order outlining DTC's plans to offer a service under which it will "open a custodial account in a local market with an agent bank or central securities depository * * * that will hold shares on DTC's behalf. DTC's participants will be able to communicate with DTC with respect to foreign

agrees that cost-related information of the type the Commission has asked us to provide is important, we also urge that the Commission solicit comment on a broader issue -- the policy rationale for the creation of two different regulatory frameworks under which an investment company may maintain assets in the custody of a foreign depository. The differences between these two approaches are briefly summarized below. In addition, we have prepared a chart, a copy of which is enclosed, comparing the two regulatory frameworks in more detail.

Rule 17f-7 is based on the principle that the risk associated with the use of a foreign depository should be considered, along with other factors, by a fund's board or investment adviser when the fund decides whether to invest in securities that trade in a particular country's markets. Rule 17f-7 recognizes that foreign risk is a matter of degree, and that different funds are willing to accept different levels of risk, depending on their investment objectives. In order that funds make their decisions on an informed basis, Rule 17f-7 relies on disclosure in the form of an analysis of the risk associated with the depository. The fund's custodian must provide this analysis, subject to a duty to exercise reasonable care.

In contrast, the discussion during the October 3 open meeting indicates that, when an investment company places its assets in the custody of a foreign depository through a linkage with a U.S. depository, the Commission is the arbiter of depository risk. Under this framework, there is apparently no disclosure concerning such risk to investment companies that hold foreign assets through the link because such disclosure "would be unnecessary and would be burdensome" (staff comment at October 3 open meeting). Issues such as the criteria the U.S. depository applies in deciding whether to initiate or continue a link, and the standard of care to which the U.S. depository is subject in conducting initial due diligence on, and ongoing monitoring of, its foreign partner, have not been publicly addressed.

There are stark differences between these two approaches, both in the risks and costs imposed on funds and their custodians and in underlying regulatory philosophy. The Association urges that the Commission invite comment on the implications of the two approaches, on which is preferable, and on how to harmonize them. One particularly important issue is which of the regulatory frameworks would apply in the case of a link between a U.S. depository and a transnational depository, such as

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securities as they do today with respect to currently eligible U.S. securities." This service will permit a DTC participant to "move overseas inventory from its current custodian into DTC's account at DTC's foreign custodian." Securities Exchange Act Release No. 44745, 66 Fed. Reg. 169, 45883 at 45884 (August 30, 2001).

Euroclear or Clearstream, since a link to a transnational depository could provide a portal through which U.S. institutional investors would be in a position to hold assets at many foreign securities depositories.[6]

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As noted in our prior letter, in light of the rapid internationalization of the securities markets, the Association regards the rationalization of Rules 17f-4 and 17f-7 as extremely important. Accordingly, the Association appreciates the Commission's interest in this matter and the opportunity to provide the foregoing information and views. If you or your colleagues have questions, or would like to discuss this letter, 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. We also request that a copy of this letter, and of our December 7, 2000 letter concerning Rule 17f-4, be placed in the public comment file relating to the proposed amendments to Rule 17f-4 at such time as that file is opened.

Sincerely,

Daniel L. Goelzer
Counsel to the Association of Global Custodians

Enclosure: Comparison of Custody of Investment Company Foreign Assets Through a U.S. Depository Linkage and Through a Foreign Subcustodian

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6/ For example, as noted in our December 7, 2000 letter, 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 numerous local central securities depositories. Would a Commission order permitting a U.S. depository to link to such a transnational depository constitute a finding that all of the local depositories that act as "spokes" to the transnational depository provide the same level of asset safety as does a U.S. depository? If so, on what basis would such a finding rest and how would its continuing accuracy be determined?