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February 4, 2002

BY MESSENGER

Jonathan G. Katz
Secretary
Office of the Secretary
Securities and Exchange Commission
Mail Stop 6-9
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

RE: File No. S-7-22-01/Investment Company Act Release No. 25266 (November 15, 2001) -- Custody of Investment Company Assets With a Securities Depository

Dear Mr. Katz:

The Association of Global Custodians[1] submits this letter in response to the invitation to comment on the proposed amendments to Investment Company Act Rule 17f-4 published in Investment Company Act Release No. 25266 (November 15, 2001).[2] The Release states that the proposed amendments are intended to update Rule 17f-4 to "reflect the broader range of functions today performed by securities depositories for funds"[3] and to more accurately describe how funds and custodians use depositories.

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[1] The Association of Global Custodians ("AGC" or "Association") is an informal association of nine banks that are major providers of custody services to registered investment companies. The members of the Association are The Bank of New York, Bankers Trust Company/Deutsche Bank, Brown Brothers Harriman, Citibank, N.A., Investors Bank & Trust Company, JPMorgan Chase Bank, Mellon Trust/Boston Safe Deposit & Trust Company, Northern Trust Company, and State Street Bank and Trust Company.

[2] 66 Fed. Reg. 58412 (November 21, 2001) ("the Release").

[3] Release at 58413.

The Association supports the goal of modernizing Rule 17f-4. However, we are concerned that, in some respects, the proposed amendments would create duties and impose burdens that are not consistent with the practical realities of contemporary custody practice. The Association has comments on four specific aspects of the proposed amendments --

- Rather than requiring that the custodian "take all actions reasonably necessary or appropriate," Rule 17f-4(a)(1) should provide that the arrangement under which a fund uses a depository must be "structured in accordance with applicable law in a manner reasonably designed to preserve the Fund's rights as an entitlement holder in Assets maintained by the Custodian with the Securities Depository or Intermediary Custodian for the benefit of the Fund."

- Rule 17f-4 should not require that custody contracts be amended to include particular language relating to the use of securities depositories. Funds and their custodians should have flexibility to determine how to preserve the fund's rights with respect to assets held in securities depositories.

- The requirement that custodians provide funds with internal control reports issued by domestic depositories serves no purpose and should be deleted.

- Transfer agents are not securities depositories and should not be treated as such under Rule 17f-4. While the Association supports permitting a fund to hold securities issued by another fund directly through an account maintained with the transfer agent for the investee fund, this result should not be accomplished through amendments to Rule 17f-4.

Finally, as set forth in our prior correspondence concerning this proceeding, we believe that the Commission should expressly address the use of regulated domestic depositories as access points to foreign depositories that are not subject to Commission regulation. In our view, where a fund uses the linked domestic depository through its primary custodian, the custodian should be responsible for Rule 17f-7 compliance with respect to the foreign depository. If a fund uses the domestic depository directly, the depository may have to assume responsibility for Rule 17f-7 compliance, unless the fund is able to obtain depository risk information from its primary custodian, or some other source. Similarly, if a fund uses an inter-depository link that includes a foreign bank, the domestic depository should have to cooperate in assuring that the foreign bank meets the requirements of Rule 17f-5.

Background

The Association believes that it is important to bear several basic principles in mind in connection with the regulation of fund use of domestic depositories.

First, as in the case of most foreign securities depositories,[4] the use of a domestic securities depository involves little or no element of choice on the part of a fund or its custodian. Use of the depository is essentially a consequence of the decision to invest in securities that are immobilized in that depository; there is no separate decision to select the depository. Any regulatory obligations arising from fund use of domestic depositories should recognize this fundamental premise. While it is, in theory, possible to hold some types of securities in physical form, as a practical matter fund investments in publicly traded securities are held through book entries at a securities depository or, in some cases, on the books of a transfer agent. For example, if a fund elects to purchase a security that trades on the New York Stock Exchange, that security will be held by the Depository Trust Company ("DTC"), and the fund's interest in the security will be reflected on the books of its custodian and other intermediaries. Rule 17f-4 should not be predicated on the fiction that funds or their custodians make a decision to use, or to refrain from using, particular domestic securities depositories.

Second, domestic securities depositories are akin to public utilities and are not subject to the control of particular users. Securities depositories are regulated by the Commission as clearing agencies under Section 17A of the Securities Exchange Act of 1934. Further, the nature of a domestic depository's internal controls, and other aspects of its operations, are not open to negotiation between a fund or its custodian and the depository. If a domestic securities depository is not conducting its operations in a safe and professional manner, there is little or nothing that a particular fund or custodian can do to remedy the situation -- nor is it even likely that internal weaknesses will come to a participant's attention. In contrast, the Commission has plenary authority over the rules governing the activities of registered clearing agencies; is empowered to inspect such facilities to assure compliance; and may revoke the registration of any clearing agency that fails to adhere to Commission requirements. If the Commission wishes to strengthen depository controls, it should do so directly, not by requiring individual users to monitor depositories.

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[4] See, e.g., Letter, dated July 15, 1999, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, from Daniel L. Goelzer, Re: File No. S7-15-99 -- Custody of Investment Company Assets Outside the United States.

Third, while the Commission has broad regulatory authority over investment companies under the Investment Company Act, it is not the primary regulatory authority for custodians. Most, if not all, custodians for registered investment companies are banks subject to the regulatory authority of one or more of the state and federal bank regulatory agencies. Therefore, the Commission's custody rules should be cast as requirements to which investment companies are subject, not as direct obligations of custodians.

Discussion of Proposed Amendments

With this background in mind, the Association has the following comments on the proposed amendments to Rule 17f-4. Attachment A is a revised version of Rule 17f-4 that incorporates the Association's comments.

1. **The proposal that custody contracts with respect to Assets held in securities depositories require that the custodian take "all actions reasonably necessary * * * to safeguard Assets" is over-broad and could impose duties beyond those arising under UCC Article 8.**

Proposed Rule 17f-4(a)(1)(i) would require that a fund's contract with its custodian provide that the custodian will --

> "take all actions reasonably necessary or appropriate under applicable commercial and regulatory law to safeguard Assets maintained by the Custodian with a Securities Depository or Intermediate Custodian for the benefit of the Fund."

This new contractual provision would replace the specific actions that must be "elements" of the "arrangement" pursuant to which fund securities are deposited with a clearing agency that acts as a securities depository under existing Rule 17f-4.[5]

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[5] Existing Rule 17f-4(d) permits an investment company's custodian to deposit securities in a clearing agency registered under Section 17A of the Securities Exchange Act, or in the Fed's book entry system, "under an arrangement that contains the following elements" (among others) --

(1) The custodian "shall deposit" the securities in an account that includes only assets held by it for customers.

The rationale offered in the Release for this change is that, in light of the 1994 amendments to Article 8 of the UCC, the specific obligations in existing Rule 17f-4 are no longer consistent with Article 8. However, the contract language in proposed Rule 17f-4(a)(1)(i) is much broader than this stated purpose. The phrase "all actions reasonably necessary or appropriate under applicable commercial and regulatory law to safeguard Assets" suggests that custodians must agree to assume a vague and potentially unlimited obligation to take discretionary actions to "safeguard" fund assets, notwithstanding that those assets are held in facilities operated by Commission-regulated clearing agencies. In fact, however, as noted above, custodians have no discretion with respect to the use of domestic securities depositories and no ability to control how those entities conduct their operations. Rule 17f-4 should focus on the investment company's obligation to structure its arrangements to preserve the fund's rights under Article 8 as an entitlement holder in securities held by a securities depository, not on ill-defined new concepts, such as what might constitute "all actions" that could be "appropriate" for an intermediary, such as a custodian, to take in order to "safeguard" assets that are held by an SEC-regulated securities depository.

For these reasons, Rule 17f-4(a)(1) should be revised to make clear that funds must require their custodians to adhere to Article 8, not to assume general responsibility for the safety of domestic depositories. In our view, Rule 17f-4(a)(1) should state that, if a fund uses a Securities Depository through its custodian, the fund must do so under an arrangement that is --

> "structured in accordance with applicable law in a manner reasonably designed to preserve the Fund's rights as an entitlement holder in Assets maintained by the Custodian with the Securities Depository or Intermediary Custodian for the benefit of the Fund."

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(2) The custodian "shall send the investment company a confirmation of any transfers to or from the account of the investment company."

(3) 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 [securities depository]."

2. The proposal should not require that specific language be included in custody contracts.

While the general standard set forth above should govern a fund's use of a securities depository through its custodian, the Commission should not require that standard, or any other, to be engrafted into all custody contracts. Rather than attempting to specify contractual terms under which investment companies would be permitted to use securities depositories through custodians, the Commission should afford funds and their custodians flexibility to structure their relationship in a manner that assures compliance with the above standard.

In general, the Association believes that regulation which sets a standard and leaves the specific means of compliance to those affected is preferable to prescriptive regulation. In the present case, cost-benefit considerations also counsel against requiring contractual amendments. As the Release recognizes, there are thousands of existing fund custody contracts. Changes to these agreements are costly to both the funds involved and their custodians. Any change requires a significant expenditure of time to propose and explain and may also involve review by outside counsel for the fund and the custodian. Board approval is typically also required. Many fund/custodian contracts have recently been amended twice -- first in response to revised Rule 17f-5, and then to implement Rule 17f-7. We urge restraint in yet again imposing these costs on the industry, absent a compelling reason to do so.[6]

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[6] The Commission estimates that the per-fund cost of modifying custody contracts would be 10 hours and $1,555. Release at note 85. Extrapolating these figures to all registered funds, the Commission estimates that the total first-year costs of contract modifications would be 45,160 hours. Footnote 86 of the Release states that this number is calculated by adding the costs associated with the renegotiation of contracts (39,770 hours) and those associated with the drafting of new contracts (5,390 hours). On this basis, the Commission estimates that the total first year cost would be $7,020,483. Id. at note 87.

We believe that these figures understate the total costs of including the proposed contract language in all fund custody contracts. First, even if the Commission's estimates are otherwise accurate with respect to funds, the Commission has not included any of the costs that would be borne by custodian banks. We believe that the costs borne by custodians incident to renegotiating custody contracts with all fund clients, revising the underlying contracts, and participating in the presentation of the amendments to fund directors would at least equal the costs borne by the funds. Second, the Commission has apparently assumed that neither funds, directors, nor custodians would consult with outside counsel concerning these amendments. We do

To afford funds and their custodians flexibility, and to avoid the costs of contract amendments, we urge that the Commission conform the language of the proposed amendment to that of the current rule. Current Rule 17f-4 does not expressly require that any particular provisions appear in custody contracts. Instead, Rule 17f-4(d) simply provides that fund assets may be held in a domestic securities depository "under an arrangement" that contains certain elements. The amendments should continue this approach. Proposed Rule 17f-4(a)(1) should be revised to state --

> "*(a) Custody arrangement with a securities depository.* A Fund or its Custodian may place and maintain Assets with a Securities Depository, *provided that:*
>
> (1) *Use of custodian.* If the Fund uses a Securities Depository through its Custodian (or through the Fund's trustee, if the Fund is a Non-Management Company), the Fund's Assets shall be maintained with the Securities Depository (or Intermediary Custodian) under an arrangement that * * *."

If this change were made, investment companies and their custodians would be free to decide whether to embody the requirements of Rule 17f-4(a)(1) in the custody contract or whether to reflect compliance with these requirements in some other manner, such as by letter from the custodian to the fund. Such a change would also prevent both funds and custodians from incurring the substantial costs associated with contract changes, but would not alter the substance of fund depository arrangements.[7]

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not believe this is correct, particularly if the final rule were to impose the kind of broad liability on custodians that is suggested in the current version of the amendments. Therefore, outside counsel legal fees should also be included in computing these costs.

[7] If the Commission -- contrary to our view -- determines that contract amendments are essential, we would suggest a separate requirement be added to the rule providing that, at such time as a fund enters into a new custody contract, or amends an existing contract, the contract must be conformed to new Rule 17f-4. Under this approach, contracts would, over time, contain the provisions of Rule 17f-4(a)(1) without the need for funds and custodians to engage in costly amendments to existing custody contracts solely for that purpose.

3. Requiring custodians to provide funds with internal control reports issued by domestic depositories is unnecessary.

Proposed Rule 17f-4 would continue the requirement in existing Rule 17f-4(d)(4) that, if a fund holds assets in a domestic depository through a custodian, the custodian must send to the investment company reports it receives from the depository on the depository's system of internal accounting control. Specifically, Proposed Rule 17f-4(a)(2)(i) would require that a fund's contract with its custodian provide that the custodian will promptly transmit to the fund --

> "periodic reports concerning the internal accounting controls and financial strength of the custodian, and available reports concerning the internal accounting controls of any Securities Depository or its operator and any Intermediate Custodian." (emphasis added)

The Association has no objection to requiring that funds receive reports concerning the internal accounting controls and financial strength of the fund's custodian. However, insofar as proposed Rule 17f-4(a)(1)(ii) would require custodians to transmit to their fund clients "available"[8] internal control reports prepared by U.S. depositories (including the Fed's book-entry system), we question the need for such a provision and whether the costs outweigh any benefits.

Requiring custodian banks to forward to their fund clients reports made available to the public by regulated entities, such as securities depositories, is an exercise in paper shuffling. There is no action that a fund would be likely to take based on such a report. As a practical matter, a fund that invests in U.S. equities has no alternative to using the depository facilities of DTC. DTC is directly regulated by the Commission. Requiring funds to receive reports on DTC's internal controls seems to imply that a fund might determine that those controls are inadequate, notwithstanding the Commission's regulation of DTC, and withdraw its assets from DTC or somehow persuade DTC to

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[8] We are also concerned that the meaning of the phrase "available reports" (which does not appear in the current rule) is unclear. We assume that the Commission is not proposing to require that custodians obtain information from U.S. depositories that the depositories do not otherwise make available to participants or to the general public. This should be made clear in the adopting release, if the Commission -- despite our views -- retains this requirement. Since the Commission regulates depositories, it is in a better position to induce these facilities to make information available concerning their internal controls than are custodian banks.

alter its controls. This is unrealistic. Requiring funds to receive such reports merely creates a paperwork burden with no offsetting potential benefit.[9]

Further, if the Commission believes that funds should obtain reports issued by depositories, it would be more appropriate for the Commission to promulgate such a requirement directly -- either by requiring funds to obtain these reports as a condition of their registration under the Investment Company Act or by requiring depositories to furnish them to funds as a condition of clearing agency registration under Section 17A of the Securities Exchange Act. The delivery requirement should not be imposed on custodian banks.

4. Transfer agents should not be deemed securities depositories.

Proposed Rule 17f-4(a)(4)(iii) would set forth the requirements that the operator of a domestic securities depository must meet in order for a fund to place and maintain assets with that securities depository. One of the alternative standards in Rule 17f-4(a)(4)(iii) is that the securities depository be --

> "A transfer agent registered with the Commission or other appropriate regulatory agency as provided in section 17A of the Securities Exchange Act of 1934 * * *, when acting as agent for an open-end registered investment company whose securities it holds."

We have no objection to codifying the ability of registered investment companies to hold securities issued by open-end funds directly by book entry on the records of the open-end fund's transfer agent. However, we urge that the Commission not accomplish this result by defining an open-end fund's transfer agent as a "Securities Depository."[10] While this aspect of the proposed amendments raises several issues, the Association's primary concern is that it will create uncertainty and confusion concerning the circumstances under which foreign transfer agents should be deemed securities depositories and therefore subject to Rule 17f-7.

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[9] In the case of funds that invest in U.S. government securities that are recorded in the Fed's book-entry system, the case against requiring delivery of internal control reports is even stronger. There is no ability to withdraw securities from this system.

[10] The phrase "Securities Depository" would be defined in proposed Rule 17f-4(b)(9).

In explaining this facet of the proposed rule, the Release states that the "amendment would acknowledge that a mutual fund's transfer agent may serve as the functional equivalent of a depository." However, there is no explanation of what is meant by the phrase "functional equivalent of a depository" or in what circumstances a transfer agent might be deemed to meet that test. This is troubling because, in the international context, there has been considerable confusion concerning whether and when transfer agents should be viewed as holding custody of the securities recorded on their books and must therefore satisfy the requirements of either Rule 17f-5 or Rule 17f-7. By treating open-end fund transfer agents as having custody of the securities reflected on their books, the Commission appears to imply that other types of transfer agents must also be treated as custodians.

The staff has previously -- and correctly in our view -- taken a contrary position. In ASX Settlement and Transfer Corporation Pty Ltd (SEC No-action letter, April 19, 1994), the staff considered whether the Clearing House Electronic Subregister System ("CHESS"), a subregistry system, was a securities depository for purposes of Rule 17f-5 (as then in effect). The staff stated that it would take no action if CHESS -- which appears to have performed transfer agent-like functions[11] -- were not deemed a depository and therefore not treated as subject to the requirements of old Rule 17f-5. The Release does not cite this letter or explain how it can be reconciled with the proposed treatment of an open-end fund transfer agent that is the "functional equivalent" of a depository.

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[11] In ASX Settlement, the staff expressly notes that CHESS operates in a manner similar to a transfer agent:

> "CHESS will not operate as a depository and will not have an associated depository. Instead, CHESS, as agent on behalf of individual issuers, will operate an electronic subregister that will be recognized at law as an integral part of each issuer's principal register of securityholders. The securities recorded on CHESS's subregister will be uncertificated. Participants in CHESS will directly control the securities holdings in CHESS. CHESS will not take physical possession of or acquire any interest in securities. CHESS will not change the nature of a securityholder's interest in securities. Securities holdings in CHESS will be registered in the name of a participant, a wholly-owned subsidiary of a participant, or, in some instances, a sponsored holder. Securities holdings will not be registered in the name of CHESS. You state that CHESS will operate the subregister in a manner similar to that of a transfer agent." (footnotes omitted, emphasis added)

In addition, it is important to recognize that transfer agents are selected by, and serve as agents of, the issuer. Unlike most securities depositories, transfer agents are not associated with particular markets or stock exchanges and are not accountable to other market participants. On the contrary, their legal obligations generally run solely to the issuer on whose behalf they act. Because they are not quasi-public institutions, transfer agents are unlikely to cooperate in the kind of transparency and information-sharing that is critical to Rule 17f-7 compliance.

The result that the Commission is seeking to accomplish through its amendments to Rule 17f-4 could be attained without creating confusion concerning whether transfer agents are depositories. Rather than defining open-end fund transfer agents as operators of securities depositories in Rule 17f-4, the Commission should adopt a free-standing rule governing the use of open-end fund transfer agents by registered funds. Alternatively, investment company direct use of transfer agents could be addressed in the context of self-custody under Rule 17f-2. Either of these approaches would avoid the conceptual problems inherent in defining transfer agents as securities depositories.

Investment Company Use of Links Between Domestic and Foreign Securities Depositories

Prior to the publication of the Release, the Association urged the Commission to consider, as part of this proceeding, the implications of fund use of domestic securities depositories as vehicles for accessing the facilities of foreign securities depositories.[12] We continue to believe that the Commission should review the policy implications of this development and should conform its regulation of foreign custody to this new reality.

As the Association has explained in its prior correspondence, the role of depositories is changing from single-market utilities to access points to custody facilities, including foreign depositories, in many jurisdictions. As a result, the regulation of foreign custody of investment company assets is, in effect, evolving into a two-tier system. Funds that hold assets in foreign depositories through traditional custodian/subcustodian networks must comply with the requirements of Rule 17f-5 and

[12] Letter, dated October 17, 2001, to C. Hunter Jones, Assistant Director, Office of Regulatory Policy, Division of Investment Management, Re: Rule 17f-4 Review/Information Regarding Rule 17f-7 Compliance Costs; and Letter, dated December 7, 2000, to Robert E. Plaze, Associate Director, Office of the Associate Director (Regulation), Division of Investment Management, Re: Review of Rule 17f-4. Both letters were sent the Office of the Secretary for inclusion in File No. S7-19-00.

Rule 17f-7. In broad terms, these rules require that a fund's Foreign Custody Manager determine whether assets held by foreign subcustodians are subject to reasonable care and that a fund's primary custodian provide the fund with information concerning the risks associated with any foreign securities depositories the fund uses.[13] In contrast, it is unclear whether funds that hold foreign assets through a linkage between a domestic depository and a foreign depository need not comply with these requirements or whether such funds may instead rely on the Commission's determination to permit the linkage. The view expressed by the staff during the October 3, 2001 open meeting was that a Rule 17f-7 analysis of a linked foreign depository is not necessary because, before permitting the linkage, the Commission's staff will have determined that use of the foreign depository does not entail depository risk.[14]

1. The Commission should harmonize Rules 17f-5 and 17f-7 and the regulation of depository linkages.

The Association urges that the Commission examine the policy rationale for the creation of these two different regulatory frameworks under which an investment company may maintain assets in the custody of a foreign depository and that it harmonize them. In our view, reliance on Rule 17f-7 risk disclosure is superior to reliance on a Commission decision to approve a depository link as a means for a fund

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[13] 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 custody 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.

[14] During the October 3, 2001 open Commission meeting, the staff stated that it 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 provide Rule 17f-7 risk analyses of linked foreign depositories would impose an unnecessary cost, since investment company securities held through an SEC-approved depository linkage are not subject to the foreign custody risks on which that rule focuses.

to determine whether and to what extent it is exposed to risk as a result of using the linked foreign depository.[15] Therefore, we believe that, when a fund accesses a foreign depository through a link between that depository and a domestic depository, the fund should still receive the type of risk analysis information prescribed by Rule 17f-7 with respect to the foreign depository. Similarly, the fund's Foreign Custody Manager should still be required to apply Rule 17f-5 to any foreign bank or trust company that is an element in a cross-border depository link.

In our view, reliance on Commission approval of a linkage is at odds with the premises on which Rule 17f-7 rests. First, Rule 17f-7 is based on the proposition that the use of any foreign depository entails some level of custody risk. That risk varies from case to case. Funds should, however, receive relevant information concerning the risk of holding assets in a foreign securities depository so they can evaluate that risk as part of the determination of whether to invest in securities that trade in the jurisdiction where the depository operates. Moreover, there is no absolute measure of foreign depository safety. Depending on their investment objectives and risk tolerance, different funds may reach different conclusions concerning the prudence of exposing the fund to the risks associated with a given depository. A governmental decision cannot take these differences into account.

If the propositions underlying Rule 17f-7 remain correct, it seems clear that Commission decisions concerning linkages between foreign and domestic depositories are not a substitute for Rule 17f-7 risk analyses. If these propositions are incorrect, then we would respectfully suggest that the Commission consider whether Rule 17f-7 continues to serve any useful purpose or whether it should be repealed. The Association believes that the conclusions on which the Commission based its recent adoption of Rule 17f-7 (and the 1997 amendments to Rule 17f-5) remain valid. Attachment B outlines how, in the Association's view, the regulation of foreign custody should be modified in light of those conclusions to accommodate cross-border depository linkages.

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[15] The Commission's decision to permit a link apparently focuses on the safety of the link itself. In any event, the Commission makes little or no information available to the public concerning the nature of the due diligence it conducts on the operations of the foreign depository or concerning how it concludes that use of the foreign depository does not entail risk. Absent a transparent process or access to risk information (such as is required under Rule 17f-7), users have no way of determining whether the Commission link approval decision is a substitute for the evaluation they would otherwise perform of Rule 17f-7 risk information. See Letter, dated October 17, 2001, supra note 12, at 4-8.

If, contrary to our view, the Commission continues to treat approval of a depository linkage as obviating the need for funds that use that link to receive Rule 17f-7 risk analysis information with respect to the foreign depository, the Commission should, at minimum, extend the logic of its position to all fund users of the depository in question. That is, a Rule 17f-7 analysis should not be required with respect to a linked foreign depository, regardless of whether a particular fund accesses that depository through its custodian or through the link with the domestic depository. If, as the staff has suggested, Commission approval of the linkage entails a finding that the depository meets some threshold safety level, both direct users and linkage users should be able to rely on that finding.

2. Responses to Commission questions.

The Release invites commentators to address several specific questions relating to fund use of depository linkages. The Association's views on these questions are set forth below.

a. Would the failure to apply rules 17f-5 and 17f-7 to domestic depositories create an unfair burden on competition between domestic depositories and global custodians of funds? If it would, should the Commission apply those rules to U.S. depositories that hold fund assets through foreign linkages?

First, we are not proposing that the Commission generally apply Rules 17f-5 and 17f-7 to domestic depositories. As set forth in Attachment B, the Association believes that, where a fund accesses a foreign depository through its custodian's account with a domestic depository, the fund's primary custodian, not the domestic depository, should be responsible for providing the fund with risk information concerning the foreign depository. In the situation (which we believe would be less common) where a fund accesses a foreign depository through a direct link with the domestic depository, the domestic depository would be required to supply the risk information concerning the foreign depository, unless the fund could obtain that information from some other source.[16]

[16] Similarly, with respect to Rule 17f-5, in some cases the fund's Foreign Custody Manager might agree to take responsibility for the Rule 17f-5 compliance of foreign banks that are elements of the cross-border depository link. However, since the foreign bank would have been selected by, and have contracted with, the domestic depository, the domestic depository would have to cooperate with the FCM.

More broadly, the Association does not view this issue as primarily a question of unfair competition. It is true that, if funds that access foreign securities depositories through their global custodians must receive Rule 17f-7 information, while funds that access the same depositories through depository linkages do not have to receive that information, competitive disparities may result.[17] However, the Association believes that the more important issue is the potential contradictory regulatory policy, outlined above, under which Commission approval of a depository linkage would obviate the need for Rule 17f-7 risk information concerning the linked foreign depository.

b. **Alternatively, should rules 17f-5 and 17f-7 be amended to provide an exception from some or all of their requirements if a fund maintains assets with a foreign custodian with which a U.S. depository has established a linkage? Would such a change impede the establishment of linkages that a U.S. depository might otherwise choose to establish?**

As discussed earlier, if the Commission declines to harmonize Rules 17f-4, 17f-5, and 17f-7 as applicable to depository linkages in the manner we have suggested in Attachment B, we believe that linked depositories should be excluded from Rule 17f-7. We see no justification to require funds that access a foreign depository through a global custodian to receive Rule 17f-7 risk information concerning that depository, while funds that access the same foreign depository through a linkage between the foreign depository and a domestic depository do not receive that information because it is deemed unnecessary in the later case to consider foreign depository risk.

We are not aware of any reason why exempting linked foreign depositories from Rule 17f-7 would impede the establishment of any linkages that a U.S. depository might otherwise choose to establish.

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[17] As set forth in the Association's October 17 letter (supra note 12) at pages 2-4, generating Rule 17f-7 risk information concerning foreign depositories imposes significant costs on custodians. While we are not aware of any data addressing the issue, presumably some portion of this cost is passed along to the funds that receive the Rule 17f-7 risk information. Therefore, a regulatory structure under which some funds and their custodians that use a particular foreign depository must bear Rule 17f-7 costs, while other funds that use the same foreign depository do not, would seem likely to have a potential competitive impact.

c. **Is there any difference in costs to funds and risks to investors, either because of differences in disclosure to funds or otherwise, between arrangements in which a fund uses a clearing agency's linkage with a foreign depository to hold custody of foreign assets, versus arrangements in which a fund holds assets in a foreign depository through a global custodian?**

In our view, there is no difference in the risks to which fund investors are exposed when their fund accesses a foreign depository by using a clearing agency's linkage with the foreign depository to hold custody of foreign assets, versus arrangements in which the fund holds assets in the foreign depository through a global custodian. In both cases, fund investors are exposed to the same level of risk that they will suffer a loss as a result of some failure or error on the part of the foreign depository. For this reason, we believe that Rule 17f-7 risk information concerning the foreign depository is of equal importance in both cases. The framework suggested in Attachment B would implement this view. With respect to cost differences, see note 17, supra.

d. **Would any of the alternatives impose unnecessary regulatory burdens, or impose overlapping or duplicative requirements? What would be the effect of each alternative on efficiency, competition, and capital formation?**

For reasons set forth earlier in this letter, we do not believe that approval of a linkage between a foreign and a domestic depository should be viewed as a Commission finding that the foreign depository is "safe" in some absolute sense. If our view is correct, requiring that funds holding assets in a foreign depository through a link with a domestic depository receive Rule 17f-7 risk information would not duplicate or overlap with the staff's depository linkage approval process. If the Commission disagrees with our view and regards approval of a link between a domestic and foreign depository as entailing a finding that the foreign depository is safe for use by any registered fund (as the staff's comments at the October 3 meeting suggested), then requiring funds that use that foreign depository through a global custodian to receive Rule 17f-7 risk information is duplicative and unnecessary. In that case, we believe that a linked foreign depository should be exempted from Rule 17f-7 for any fund that uses that depository, regardless of whether the fund uses the foreign depository through the link or through a global custodian.

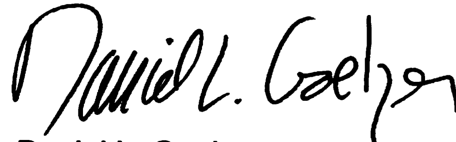
The Association's views concerning the impact of the regulatory alternatives on efficiency and competition are set forth above in response to question a. We have no

basis to determine whether either alternative would have any impact on capital formation, although, since the securities held through depositories links are, by definition, issued by non-U.S. companies, any such impact would presumably be felt principally outside the United States.

* * *

The Association appreciates the opportunity to comment on the proposed amendments to Rule 17f-4. If you have any questions concerning this letter, please contact the undersigned at 202/452-7013.

Sincerely,



Daniel L. Goelzer
Counsel to the Association

Attachments:

A -- Amended Rule 17f-4 As Proposed by the Association of Global Custodians

B -- Principles for the Harmonization of Rules 17f-4, 17f-5, and 17f-7 As Proposed by the Association of Global Custodians

ATTACHMENT A

Amended Rule 17f-4
As Proposed by the Association of Global Custodians

§ 270.17f-4. Custody of investment company assets with a securities depository.

(a) *Custody arrangement with a securities depository*. A Fund or its Custodian may place and maintain Assets with a Securities Depository, *provided that*:

(1) *Use of custodian*. If the Fund uses a Securities Depository through its Custodian (or through the Fund's trustee, if the Fund is a Non-Management Company), the Fund's Assets shall be maintained with the Securities Depository (or Intermediary Custodian) under an arrangement that:

(i) Is structured in accordance with applicable law in a manner reasonably designed to preserve the Fund's rights as an entitlement holder in Assets maintained by the Custodian with the Securities Depository or Intermediary Custodian for the benefit of the Fund; and

(ii) Provides that the Fund will promptly receive periodic reports concerning the internal accounting controls and financial strength of the Custodian, and any publicly available reports concerning the internal accounting controls of any Intermediary Custodian appointed by the Custodian.

(2) *Direct dealings with securities depository or non-management company arrangements*. If the Fund maintains Assets directly with a Securities Depository, or is a Non-Management Company:

(i) The Fund's Assets shall be maintained with the Securities Depository under an arrangement that is comparable to that required under paragraph (a)(1)(i) of this section; and

(ii) The Fund (or the Fund's trustee, if the Fund is a Non-Management Company) shall implement internal control systems reasonably designed to prevent unauthorized Officer's Instructions (by providing at least for the form, content, and means of giving, recording, and reviewing all Officer's Instructions).

(3) *Fund's approval.* An officer of the Fund (or a trustee of a Fund that is a Non-Management Company) has approved each of the Fund's own custody arrangements with its Custodian or with a Securities Depository under this paragraph (a).

(4) *Operators of a securities depository.* The Securities Depository is operated by:

(i) A Federal Reserve Bank or other person authorized to hold custody of securities in the federal book-entry system described in regulations of the United States Department of the Treasury codified at 31 CFR Part 357, Subparts B and C, or comparable regulations of other federal agencies affecting the book-entry system; or

(ii) A clearing agency registered with the Commission under section 17A of the Securities Exchange Act of 1934 (15 U.S.C. 78q-1).

(b) *Definitions.* For purposes of this section:

(1) *Assets* means cash and securities and similar investments that are owned by the Fund or held by another person for the benefit of the Fund.

(2) *Custodian* means a bank or other person authorized to hold Assets for the Fund under section 17(f) of the Act (15 U.S.C 80a-17(f)) or Commission rules, but does not include a Fund itself, a Safekeeping Facility, or a Foreign Custodian.

(3) *Foreign Custodian* means a custodian whose use is governed by § 270.17f-5 or § 270.17f-7.

(4) *Fund* means an investment company registered under the Act.

(5) *Intermediary Custodian* means any subcustodian through which a Custodian maintains any Assets with a Securities Depository, if the subcustodian is qualified to act as a Custodian.

(6) *Officer's Instruction* means a request or direction to a Securities Depository or its operator in the name of the Fund by one or more persons authorized by the Fund's board of directors (or by the Fund's trustee, if the Fund is a Non-Management Company) to give it.

(7) *Non-Management Company* means a Fund that is a unit investment trust or a face-amount certificate company.

(8) *Safekeeping Facility* means any vault, safe deposit box, or other repository for safekeeping maintained by a bank or other company whose functions and physical facilities are supervised by a federal or state authority, if the Fund maintains its own Assets there in accordance with § 270.17f-2.

(9) *Securities Depository* means a system for the central handling of Assets in which Assets are treated as fungible and are transferred, pledged, or otherwise acquired or disposed of by bookkeeping entry without physical delivery, or by physical delivery within or through the system.

NOTE to § 270.17f-4: If a Fund's (or its custodian's) custody arrangement with a Securities Depository involves one or more Eligible Foreign Custodians (as defined in § 270.17f-5) through which assets are maintained with the Securities Depository, § 270.17f-5 will govern the Fund's (or its custodian's) use of each Eligible Foreign Custodian.

ATTACHMENT B

Principles for the Harmonization of Rules 17f-4, 17f-5, and 17f-7 As Proposed by the Association of Global Custodians

To harmonize Rules 17f-4, 17f-5, and 17f-7, the Commission should address two situations --

a. Situation #1: Fund assets are held in a foreign securities depository through a link between that foreign securities depository and a domestic depository.

In situation #1, the fund's relationship with the foreign securities depository should be fully subject to Rule 17f-7. Therefore, if "the Fund uses a Securities Depository through its Custodian" [proposed Rule 17f-4(a)(1)], as its means of accessing the domestic depository's link to the foreign depository, the fund's primary custodian would be responsible for Rule 17f-7 compliance. From the perspective of Rule 17f-7 compliance, the fund's custodian would have the same responsibilities as if the fund accessed the foreign depository through the custodian and its subcustodian bank in the market in which the foreign depository operates without the involvement of a domestic depository.

However, if "the Fund maintains Assets directly with a Securities Depository, or is a Non-Management Company" [proposed Rule 17f-4(a)(2)], as its means of accessing the domestic depository's link to the foreign depository, the domestic depository should have back-up responsibility for Rule 17f-7 compliance. If the fund is able to obtain Rule 17f-7 information elsewhere, the domestic depository would be relieved of any obligation. In many cases, a fund may be able to obtain the risk analysis required under Rule 17f-7 from its primary custodian, even if the primary custodian is not a party to the arrangement between the fund and the foreign depository. Other commercial sources for this information may also be available. However, since the domestic depository is the only party to the arrangement through which the fund accesses the foreign depository, the domestic depository may have to assume responsibility for Rule 17f-7 compliance if other sources of risk information are not available to funds that utilize its foreign depository links.

b. Situation #2: Fund assets are held in a foreign bank or trust company through a link between that foreign bank or trust company and a domestic depository.

In situation #2, the domestic depository's link to a foreign depository includes the use of a foreign bank. In this case, Rule 17f-5 should apply to the fund's use of that foreign bank. Stated differently, the Fund's Foreign Custody Manager should have to perform all of the Rule 17f-5 responsibilities with respect to the domestic depository's subcustodian.

However, since the foreign bank would be selected by the domestic depository, the domestic depository should be required to provide information and cooperate with the Foreign Custody Manager. For example, the domestic depository should be required --

- to provide the FCM with information based on which the findings required in Rule 17f-5(c)(1) can be made;
- to provide the FCM with a copy of the domestic depository's contract with the foreign bank so that it can be determined whether the contract complies with Rule 17f-5(c)(2); and
- to establish a system for monitoring the foreign bank and to provide the FCM with the results of that monitoring in order that the FCM can fulfil its responsibilities under Rule 17f-5(c)(3).

If the FCM determined that it was unable to comply with the requirements of Rule 17f-5 with respect to the domestic depository's foreign bank subcustodian, the fund could not use the link in which that subcustodian was an element. Moreover, the U.S. bank that acts as a fund's FCM could not, of course, be compelled to accept FCM responsibility with respect to a domestic depository's foreign subcustodian banks, if it did not wish to do so. If a fund could not delegate FCM responsibility with respect to the depository's foreign subcustodian banks, the fund's board of directors would be the FCM with respect to such banks. If fund board did not wish to perform this function, the fund would not be able to hold foreign assets through depository linkages that involved the use of foreign banks.