THE ASSOCIATION OF GLOBAL CUSTODIANS

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May 24, 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:

On February 4, 2002, the Association of Global Custodians[1] submitted a letter[2] in response to the above-captioned release which invites public comment on certain

[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, Brown Brothers Harriman, Citibank, N.A., Deutsche Bank Trust Company Americas, 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] See Letter, dated February 4, 2002, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, from Daniel L. Goelzer, on behalf of the Association of Global Custodians, Re: Investment Company Act Release No. 25266

proposed amendments to Rule 17f-4 under the Investment Company Act of 1940 ("Act").[3] The Association is submitting this supplemental letter to address certain issues that have been raised in this proceeding by the Investment Company Institute ("ICI")[4] concerning the relationship between Rule 17f-4 and Article 8 of the Uniform Commercial Code ("UCC").

In the Association's view, the ICI Letter contains several suggestions that, if implemented, would be inconsistent with the custody practice and with Section 17(f) of the Act. In particular –

- Rule 17f-4 should not be redrafted based on the notion that investment companies do not actually own the securities that they report to their shareholders as comprising the fund's portfolio, but are merely the holders of "entitlements" to securities that are actually owned by their custodians. Article 8 does not transfer ownership of financial assets to intermediaries. Even if it did, this would not be a sound basis for the Commission's discharge of its statutory obligation to protect fund investors by regulating the custody of investment company assets under Section 17(f).

- Rule 17f-4 should not be revised to reflect the fiction that fund custodians decide whether or not to hold fund assets in domestic securities depositories. In fact, the use of Commission-registered depositories to hold the securities of institutional investors is uniform practice in the United States, and it would be unusual for an investment company's custodian, on its own volition, to make a decision to hold a fund's securities in certificate form, rather than through the facilities of the Depository Trust and Clearing Corporation ("DTCC") or another registered depository. Revising Rule 17f-4 so as to ignore this reality and instead

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(November 15, 2001) -- Custody of Investment Company Assets with a Securities Depository ("Association Letter").

[3] 66 Fed. Reg. 58412 (November 21, 2001) ("the Release").

[4] See Letter, dated January 31, 2002, from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, Re: Custody of Investment Company Assets with a Securities Depository (File No. S7-22-01) ("ICI Letter").

treat depository use as a decision falling under the discretion of fund custodians would accomplish nothing except confusion.[5]

- Rule 17f-4 should not be re-cast as a regulation of custodians, rather than of registered investment companies. Under the Act, the Commission's mandate is the regulation of investment companies, not of banks. Further, as Congress reiterated by its recent enactment of the Gramm-Leach-Bliley Act, the Commission does not have the authority to directly regulate banks that act as custodians of investment company assets.

Our views concerning these points are set forth in greater detail below. While the Association's February 4 letter suggests some changes to the Commission's proposed amendments to Rule 17f-4, we strongly urge that the Commission preserve the basic approach reflected in existing Rule 17f-4 and in the amendments proposed in Release No. 25266.

A. Rule 17f-4 should not be redrafted based on the notion that investment companies do not own securities.

The ICI letter suggests that, when a fund deposits portfolio securities with a securities intermediary, those securities "should not be treated as the 'assets' of the fund." (ICI Letter at 4). Instead, the fund should be deemed to hold merely a "securities entitlement" in the underlying assets. From this conclusion, the ICI reasons that a fund custodian's use of a securities depository is "a means by which the custodian maintains its own financial assets."[6] Accordingly, in the ICI's view, Rule 17f-4 should require the

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[5] Indeed, the same issue arose in the Commission's proceeding to revise Rule 17f-5. Ultimately, the Commission recognized that it was not realistic to predicate Rule 17f-5 on the theory that custodians have a choice with respect to the use of foreign securities depositories. As a result, foreign depositories were made the subject of Rule 17f-7, which, unlike Rule 17f-5, does not provide for delegation to custodians of the responsibility to decide whether or not a fund's assets should be placed with a particular foreign depository. It is ironic that this same issue has now arisen in connection with Rule 17f-4. For the same reasons as in the earlier proceeding, the Commission should not treat domestic depositories as subject to "selection" by custodians.

[6] See ICI Letter at 2.

custodian, not the fund, to discharge certain responsibilities and meet certain standards of performance with respect to assets held at a depository. Conversely, under the ICI's proposal, the fund would apparently have no direct responsibilities at all with respect to the maintenance of the assets.

While it is correct that the fund's deposit of securities with a custodian creates a "securities entitlement" in the underlying securities in favor of the depositor,[7] it does not follow that the custodian becomes the "owner" of the fund's assets. And, it also does not follow that Rule 17f-4 should be amended to eliminate fund responsibility for the conditions under which fund assets are held in depositories and to replace those responsibilities with custodian performance standards.

1. **Article 8 does not shift asset ownership from funds to their custodians.**

Under Article 8, the custodian is not the "owner" of the fund's financial assets. The concept of a securities entitlement is simply the means that the drafters of revised Article 8 employed to address the indirect holding system that has evolved in the U.S. securities markets; the entitlement holder concept was not designed to make a securities intermediary the owner of financial assets held by it in custody.[8] Rather, a "securities entitlement" is a package of rights that an accountholder has against its securities intermediary with respect to the positions carried in a securities account. When the accountholder (i.e., the beneficial owner) sells a financial asset held in a securities account, the entitlement is extinguished, and the purchaser acquires a new securities entitlement against its securities intermediary.

Section 8-503 does recognize that entitlement holders cannot realistically have a specific property interest in a particular financial asset when the intermediary holds an

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[7] See Section 8-501.

[8] Entitlements constitute the value of ownership of the financial asset and benefit solely the owner of the financial asset, not the owner's securities intermediary. As provided in Section 8-102(14)(ii), the intermediary holds securities accounts, not as an owner, but "on behalf of others." The Commission's custody rules also reflect this concept. See Rule 17f-5(c)(2)(i)(D) (subcustodian must agree to maintain "adequate records * * * identifying the Foreign Assets as belonging to the fund or as being held by a third party for the benefit of the fund."). (emphasis added)

asset on behalf of more than one entitlement holder. Section 8-503(b) states that the entitlement holder's interest is "a pro-rata property interest in all interests in that financial asset held by the securities intermediary * * *." However, Section 8-503 and comment 1 thereto expressly state that this pro-rata rule does not change the ownership of the financial assets as between the entitlement holder and the intermediary and that securities held by an intermediary "for the entitlement holders, are not property of the securities intermediary * * * ."[9]

In addition, Section 8-503 provides that, with respect to a securities intermediary's obligation to satisfy all securities entitlements regarding a specific financial asset, "all interests in that financial asset held by the securities intermediary are held by the securities intermediary for the entitlement holders [and] are not property of the securities intermediary * * *."[10] (emphasis added) Indeed, but for the fund's

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[9] Comment 1 to Section 8-503. (emphasis added) The full text of this comment states:

> This section [8-503] specifies the sense in which a security entitlement is an interest in the property held by the securities intermediary. It expresses the ordinary understanding that securities that a firm holds for its customers are not general assets of the firm subject to the claims of creditors. Since securities intermediaries generally do not segregate securities in such fashion that one could identify particular securities as the ones held for customers, it would not be realistic for this section to state that 'customers' securities' are not subject to creditors claims. Rather subsection (a) provides that to the extent necessary to satisfy all customer claims, all units of that security held by the firm are held for the entitlement holders, are not property of the securities intermediary, and are not subject to creditors' claims, except as otherwise provided in Section 8-511. (emphasis added)

Thus, Article 8 recognizes the fundamental principle that the custodian does not own securities held in a custody account.

[10] Further, the Prefatory Note to Article 8 states that, "Section 8-503 provides that these financial assets are held by the intermediary for the entitlement holders, are not the property of the securities intermediary, and are not subject to claims of the intermediary's general creditors." Prefatory Note I.C. (Indirect Holding System).

interests in the assets held by the intermediary, the intermediary would have no reason to hold the financial assets in question.

The ICI Letter suggests that the intermediary's ownership of fund assets it holds in a securities depository is evidenced by the fund's inability to enforce its rights against the depository. Frequently, however, custody and subcustody agreements provide for the direct or indirect enforcement of a fund's rights against subcustodians and/or depositories and may allow for direct enforcement through subrogation in certain circumstances. In addition, Section 8-503 would permit a fund, in some circumstances, to enforce its rights against a "purchaser".[11]

2. Article 8 does not absolve investment companies from responsibility for the custody of fund assets.

Rather than becoming enmeshed in Article 8 law, the Commission should focus its revision of Rule 17f-4 on the language and objectives of Section 17(f) of the Act. Section 17(f)(2) provides that, subject to Commission rules, a fund or its custodian "may deposit all or any part of the securities owned by such registered management company" in a securities depository. (emphasis added) Nothing in Section 17(f), which was recently amended[12] -- long after the approval of revised Article 8[13] -- suggests that Congress viewed investment company assets as actually belonging to fund custodians

[11] A custodian bank is frequently the nominal or record owner of client assets. A bank trustee may also use a nominee to hold title to trust assets. However, in these situations, the bank's nominee entity only holds bare title, and the use of nominees does not make the bank (or its nominee entity) the "owner" of the assets in the sense in which the ICI Letter appears to use that term. Moreover, such nominee ownership is not a consequence of the operation of the UCC; rather, it is a time-honored mechanism for segregating client assets from those of the bank. Because of its focus on securing creditors rights, Article 8 must be sensitive to how title is held. However, Rule 17f-4, which focuses on the protection of shareholder assets, should not confuse beneficial ownership and bare title (i.e., record ownership).

[12] See note 24, infra.

[13] The American Law Institute and the National Conference of Commissioners on Uniform State Laws approved revised Article 8 in 1994.

or that Congress envisioned that the Commission's ability to regulate investment company use of depositories could be abrogated by state law, such as the UCC.[14]

Article 8 is not inconsistent with this view. The drafters recognized that other regulatory regimes may supercede the objectives of the UCC and that Article 8 is not intended to disturb other legal and regulatory principles. The Prefatory Notes to Article 8 state:

> Revised Article 8 is not, and should not be, a comprehensive body of private law governing the relationship between brokers and their customers, nor a body of regulatory law to police against improper conduct by brokers or other intermediaries. Many, if not most, aspects of the relationship between brokers and customers are governed by the common law of contract and agency, supplemented or supplanted by federal and state regulatory law. If there are gaps in the regulatory law, they should be dealt with as such; Article 8 is not the place to address them.[15]

While the Association agrees that the wording of proposed Rule 17f-4 should not be inconsistent with Article 8, we also believe that Article 8 does not tie the Commission's hands regarding the allocation of rights and responsibilities under Section 17(f). The ICI is incorrect in its statement that a securities intermediary's duty under Article 8 is "imposed by law and cannot be waived."[16] On the contrary, Section 8-509 recognizes that the duties imposed by Article 8 may be varied by other laws or

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14 As noted in the Association's Letter, "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 * * *." Association Letter at 5. One of Congress's objectives in enacting the securities laws was to supplement the protections available under state law. As a result, the securities laws should not be limited by state law concepts.

15 Prefatory Comments to Article 8, Section III, last paragraph.

16 ICI Letter at 4.

regulations and that compliance with those laws and regulations satisfies the UCC.[17] Article 8 does not provide a reason to structure the Commission's rules implementing Section 17(f) of the Act on the theory that investment company assets are actually owned by the fund's custodian, rather than by the fund itself.

B. Rule 17f-4 should not be revised to reflect the fiction that fund custodians decide whether or not to hold fund assets in domestic securities depositories.

The ICI's proposed version of Rule 17f-4 provides that a fund's custodian "may maintain" fund assets with a securities depository, provided that the custodian complies with certain, specified requirements.[18] This proposal, like the related portions of the ICI Letter,[19] is predicated on the idea that a fund's custodian has discretion in the means by

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17 Section 8-509(a) provides that, "[i]f the substance of a duty imposed upon a securities intermediary by Sections 8-504 through 8-508 is the subject of other statute, regulation, or rule, compliance with that statute, regulation, or rule satisfies the duty."

18 See Attachment to ICI Letter, Proposed Rule 17f-4(a).

The ICI also suggests adding the standard of care in UCC Section 8-504 as the "default standard" of care imposed on intermediaries in maintaining the necessary quantity of assets to cover deposits. See ICI Letter at 5; Attachment to ICI Letter, Proposed Rule 17f-4(a)(1). If this "default standard" is meant to govern the relationship between the custodian and the depository, it will not be attainable. While the fund and its custodian can negotiate a standard of care to govern their relationship, depositories do not negotiate their terms of service with individual participants. If the Commission believes that registered clearing agencies that operate depositories should agree to adhere to a particular standard of care, it should amend its rules under Section 17A to so require.

19 The ICI states that Article 8-504 imposes a duty on custodians to select depositories (and intermediaries) with due care in accordance with reasonable commercial standards. ICI Letter at 7. In fact, however, Article 8-504 is completely silent on this issue. Moreover, the drafters of the UCC expressly stated that "Article 8 deals with how interests in securities are evidenced and how they are transferred," not with the conduct of parties, such as the selection or use of particular intermediaries.

which it holds the securities of its clients, including discretion as to whether, and on what terms, to use a domestic securities depository. As the Association has indicated in prior comment letters regarding Rule 17f-5 and 17f-7, this is incorrect.[20]

Market structure and practice dictate whether fund securities will, or will not, be held through the facilities of a depository. In the United States, institutional use of depositories is nearly universal. While it may sometimes be theoretically possible to hold securities outside of a depository in the form of physical certificates,[21] doing so would render the securities represented by such certificates illiquid. It would almost certainly also expose the fund's assets to greater risk of loss or theft and may not be permissible under the arrangements between the fund and its custodian. Accordingly, it is hard to conceive of a situation in which a fund's custodian would elect to withdraw a fund's assets from DTCC and hold those securities in physical form, absent an express instruction from the fund to do so.

For this reason, Rule 17f-4 should not be drafted as if the decision to use a U.S. depository rests with the custodian, rather than with its fund client. In fact, it is the investment company, by virtue of its investment decisions, not the custodian, that controls whether or not to use a depository.[22] The use of the depository is a corollary to

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Imposing new duties of care with respect to the selection of intermediaries is outside the scope of Article 8. See Prefatory Note to Article 8, III.B ("Scope of Article 8").

[20] See Letter, dated July 15, 1999, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, from Daniel L. Goelzer at 14; and Letter, dated December 11, 1997, to Douglas J. Scheidt, Chief Counsel, Division of Investment Management, from Daniel L. Goelzer at 2-7.

[21] In some cases, use of a depository is not even theoretically avoidable. For example, U.S. treasury securities can only be held through the book-entry system administered by the Board of Governors of the Federal Reserve System.

[22] Further, as noted in the Association Letter, under Section 17A of the Securities Exchange Act, the Commission has broad regulatory authority over clearing agencies. If (contrary to the Association's view) fund use of domestic depositories is thought to be risky or problematic, it would be more logical for the Commission to exercise its Section 17A authority to correct these problems, rather than seeking to protect funds against domestic depository risk by imposing new obligations on fund custodians.

the fund's decision to invest in securities handled by that depository. Therefore, Rule 17f-4 should not be phrased as if custodians decide whether or not to use a depository to hold fund assets and may only elect to do so if they satisfy certain requirements.

C. Rule 17f-4 should not be re-cast as a regulation of custodians, rather than of registered investment companies.

Proposed Rule 17f-4(a)(1), as set forth in the Attachment to the ICI Letter, is a regulation applicable to fund custodians. This proposal would impose no obligations on funds. The only party that would have duties under this version of Rule 17f-4(a)(1) would be the fund's custodian. We do not believe that a rule of this nature would be consistent with the Commission's authority or with the purposes of the Act.[23]

Under Section 17(f) of the Act, the Commission's mandate is the regulation of investment company custody practices, not the regulation of custodians. The existing rules under Section 17(f) -- including existing Rule 17f-4 -- reflect this principle. All of the current rules impose obligations, or set conditions, that are applicable to investment companies rather than to custodians. To the extent that the current rules have the practical effect of requiring that custodians take certain actions, it is because investment companies are only permitted to place assets with custodians that agree to comply with particular conditions or to perform particular acts. Custodians cannot be direct violators of these rules, since it is the investment company, not the custodian, that is regulated.

Moreover, in the case of fund custodians that are banks, Congress has declined to authorize the Commission to impose direct regulations, and has placed such institutions under the jurisdiction of the federal bank regulatory agencies. The recent enactment of the Gramm-Leach-Bliley Act confirms that the Commission does not have the authority to regulate directly banks that act as custodians of investment company assets. Section 211 of the Gramm-Leach-Bliley Act amended Section 17(f) of the Investment Company Act to give the SEC the power to regulate bank custody only

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[23] In this regard, it is significant that all of the Congressional findings declarations of policy on which the Act is based refer to the practices of investment companies and their affiliates. There is no suggestion that Congress intended to empower the Commission to regulate the activities of unaffiliated banks that provide services to investment companies. A rule of this nature would be unprecedented.

when the bank is acting as a custodian for an affiliated investment company.[24] Section 211 does not confer general authority on the Commission to regulate bank custody of investment company assets. Conversely, if the Commission had the authority to regulate banks acting as custodians for investment companies, Section 211 would be superfluous – there would have been no reason to confer on the Commission authority to regulate banks that act as custodians for affiliated funds if the Commission were already generally empowered to regulate banks acting as custodians.

* * *

There is much in the ICI Letter with which the Association agrees. However, for the reasons set forth above, we urge that the Commission not adopt the changes in the underlying philosophy of the rule that are set forth on pages 3 through 5 of the ICI Letter and in the corresponding sections of the attachment thereto.[25]

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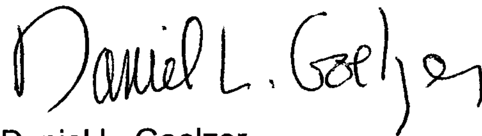
24 Section 211 of the Gramm-Leach-Bliley Act of 1999, Pub. Law 106-102, 113 Stat. 1338, amended Section 17(f) of the Act to add Paragraph 17(f)(6), which provides:

> The Commission may, after consultation with and taking into consideration the views of the Federal banking agencies (as defined in section 3 of the Federal Depository Insurance Act), adopt rules and regulations, and issue orders, consistent with the protection of investors, prescribing the conditions under which a bank, or an affiliated person of a bank, either of which is an affiliated person, promoter, organizer, or sponsor of, or principal underwriter for, a registered management company, may serve as custodian of the registered management company.

25 In considering the ICI's proposal, the Commission should also bear in mind the ramifications for foreign custody. Section 7 of the ICI Letter suggests that foreign securities held in a foreign depository through a U.S. depository link would be subject to Article 8. In fact, the application of the provisions of the UCC to cross-border holdings is far from clear. If Article 8 were to be applied to cross-border holdings, U.S. intermediaries, including U.S. depositories, could find themselves exposed to significant risk as a result of inconsistencies between U.S. and foreign law. Under Article 8, the intermediary would, under the ICI's approach, apparently be required to maintain "ownership" of assets held for clients or depositors in a foreign market. However, under

The Association appreciates the opportunity to submit this supplemental comment on the issues raised by 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

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the law of the foreign market, the intermediary may not be recognized as having as same rights as its U.S. counterpart under Article 8. Since the nature of the legal rights, if any, of an intermediary in securities held for clients in a particular country is a matter of local law, it would be unreasonable to expose intermediaries to the risk that foreign courts will not recognize the application of the UCC to assets held in their jurisdiction. In any event, the Commission should not premise its revisions to Rule 17f-4 on conjecture concerning how the U.S. and foreign courts would resolve these complex conflict of laws issues.