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December 11, 1997

Investment Company Act Rule 17f-5(c)

VIA MESSENGER

Douglas J. Scheidt
Chief Counsel
Office of Associate Director (Chief Counsel)
Division of Investment Management
Securities and Exchange Commission
Mail Stop 5-6, Room 5007
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Request For Interpretive Advice Concerning the Application of Investment Company Act Rule 17f-5(c) to Certain Depositories

Dear Mr. Scheidt:

On behalf of the Association of Global Custodians ("Association"),[1] I am writing to request that the Staff of the Division of Investment Management ("Staff") advise us concerning the application of Investment Company Act Rule 17f-5(c) to a foreign depository "that, as a practical matter, must be used if the fund is going to place assets in that country."[2] The issue requiring clarification is whether compulsory depositories must be "selected" by the fund's Foreign Custody Manager ("FCM") under Rule 17f-5(c). We ask that the Staff confirm that the decision to place and maintain assets with a compulsory depository is part of the

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1/ The Association is an informal group of ten U.S. banks that are major providers of global custody services to U.S. mutual funds. The Association is the successor to the Coalition of Custodian Banks which was an active participant in the Commission's recent proceeding to amend Rule 17f-5. See Investment Company Act Release No. 22658 at n.19 (May 12, 1997), 62 Fed. Reg. 26923 (May 16, 1997)("Adopting Release")(citing Coalition's comment letters).

2/ Adopting Release at 14. The Commission described such a depository as a "compulsory depository." Id.

decision to invest in the securities markets of the country in which that depository operates and that there need be no selection of a compulsory depository as a subcustodian under Rule 17f-5(c).

To impose the Rule 17f-5(c) selection process would ignore the reality that the decision to invest in a particular security is inevitably also a decision to use any depository that is compulsory for that security. No "selection" is possible, just as one cannot select the stock exchange on which the security trades, the currency in which it is denominated, or the system through which the transaction is cleared and settled. Therefore, it is important that compulsory depositories be assessed as part of the overall investment decision and not treated as if they are subcustodians that can be selected or rejected based on the criteria in Rule 17f-5(c). This approach is consistent with the philosophy concerning country risk set out in the Adopting Release. It also permits both the country-risk decision maker (i.e., the fund's board of directors or investment adviser) and the FCM (i.e., the fund's board, unless the adviser, or a bank, such as the fund's global custodian, accepts a delegation) to each bring their particular expertise to bear in evaluating the fund's use of compulsory depositories.

If the Staff -- contrary to our view -- were to require that the placement of assets with a compulsory depository be treated as if it were a selection within Rule 17f-5(c), more workable criteria for the assessment of compulsory depositories should be formulated. Our interpretation avoids the need to undertake this exercise, keeps compulsory depositories within the framework of Rule 17f-5, and permits investment company boards, advisers, and custodian banks to allocate responsibility concerning compulsory depositories in a manner consistent with their respective capabilities.

A. Compulsory Depositories Are Part of Country Risk.

In adopting the recent amendments to Rule 17f-5, the Commission determined that risks that are an unavoidable element of the decision to invest in a particular country should not be addressed under the rubric of selecting local subcustodians:

> Once a decision has been made to invest in a country, prevailing country risks cannot be avoided, except by maintaining assets outside of the country -- an alternative that is often not possible or practicable. For that reason, prevailing country risks would seem inherently a part of the investment risks associated with

the decision to invest in a particular country and should be considered by a fund's board or investment adviser before the fund invests in a foreign country. Inclusion of prevailing country risks in rule 17f-5, therefore, would appear inconsistent with the nature of those risks.

* * *

Based upon these considerations, the Commission has decided not to address prevailing country risks in rule 17f-5. Rather, the Commission believes that such risks should be carefully considered by a fund's board or its investment adviser before the fund invests in a foreign country, and, if material, disclosed to fund investors. Accordingly, the amended rule focuses exclusively on the selection and monitoring of an eligible foreign custodian.

Recognizing that compulsory depositories are part of country risk harmonizes these Commission objectives with the practical realities of foreign investment. If a depository must be used in order to invest, there is simply no separate decision to be made concerning the "selection" of that depository -- it is one of the "risks [that] cannot be avoided".[4]

3/ Adopting Release at 8-10 (emphasis added, footnotes omitted). The Commission also emphasized that it regarded a country's clearing and settlement system, and other components of the financial infrastructure, as part of prevailing country risk. Id. at 10-11. Indeed, the Commission noted that, although it had proposed a definition of "compulsory depository" in an early version of the rule, the removal of the elements of country risk from Rule 17f-5 eliminated the need for such a definition: "Because the amended rule does not address the decision to place fund assets in a country, the Commission has concluded that it is not necessary for the rule to distinguish between compulsory depositories and other types of foreign custodians." Id. at n. 29.

4/ Id. at 9. If compulsory depositories are subject to the selection process in Rule 17f-5(c), it may follow that only the fund's board or its investment adviser can serve as the FCM with respect to a compulsory depository because the selection of the depository is inextricably intertwined with investment decision-making.

Moreover, requiring that compulsory depositories be selected (or not selected) as local custodians under the procedures in Rule 17f-5(c) would result in a conundrum that the Commission expressly sought to avoid. If the fund's board or other FCM were unable to make the specific findings required by Rule 17f-5(c) with respect to a compulsory depository, fund securities purchases in that country would be prohibited, despite the board's decision to make such investments. The Commission declined to afford FCM's this kind of veto-power: "Such a result is inconsistent with the overall approach of the Investment Company Act, which generally does not limit a fund's ability to assume investment risks."[5]

B. <u>Treating Compulsory Depositories as Part of Country Risk Permits an Informed Assessment of Depository Risk</u>.

Our interpretation does not ignore the need to evaluate the use of a compulsory depository. On the contrary, applying Rule 17f-5 in the fashion we recommend addresses the asset-protection objectives of Section 17(f), but without intermingling country risk decisions and subcustodian selections.

First, compulsory depositories remain regulated under Rule 17f-5 in two important ways:

1. Despite the fact that compulsory depositories cannot be selected under Rule 17f-5(c), these entities can be tested against the eligibility requirements of Rule 17f-5(a)(1). This, in turn, requires a determination that the depository "acts as a system for the central handling of securities or equivalent book entries" and that it is "regulated by a foreign financial regulatory authority."

2. In most cases, fund assets are held at a compulsory depository through the account of a local bank that is a depository participant. The selection of that local bank as a subcustodian of fund assets requires a determination

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5/ <u>Id</u>. at 9. The Commission also stated that it was "concerned that restrictions on a fund's approach to prevailing country risks may have the effect of denying funds and their shareholders overseas investment opportunities, particularly in developing markets" and that "such a result is not mandated by section 17(f), the legislative history of which suggests that the section was intended primarily to prevent misappropriation of fund assets by persons having access to assets of the fund." <u>Id</u>.

under Rule 17f-5(c)(1) that the local bank will afford reasonable care and that there is a custody contract meeting the requirements of Rule 17f-5(c)(2). Further, the local bank custodian should be responsible for exercising reasonable care in its interaction with the compulsory depository.

In addition, this approach permits the board or investment adviser and the fund's global custodian to each play a role that is consistent with its expertise. The responsibility of the investment decision maker is to reach an overall decision concerning whether to invest in a country's markets. In reaching that decision, the risks associated with a compulsory depository should be evaluated, along with other financial infrastructure risks. However, since that decision process is outside of Rule 17f-5, there are no mandatory factors that must be explored, and no specific findings that must be made. The country risk decision maker can treat a compulsory depository as exactly what it is -- one of several components of the financial infrastructure over which the fund has no control and as to which there are no alternatives. Like all other investment decisions, the decision to invest in a given country would enjoy the usual protections of the business judgment rule. This allows funds flexibility in making investments, while also recognizing the unique nature of compulsory depositories.

The global custodian can, in turn, aid in determining whether a particular foreign depository is, in fact, compulsory; serve as an ongoing information source concerning the practices and regulation of the depository;[6] and accept delegated authority to select and monitor the fund's depository participant. These are functions that custodians are well-qualified to fulfill and that are compatible with their traditional responsibilities.

6/ The Adopting Release (at 10-11) states that the amendments do not "diminish the importance of considering the financial infrastructure of a foreign country" and that the Commission expected that "fund boards and investment advisers, in making foreign investment decisions, will continue to seek and rely on information and opinions provided by the fund's custodian when the custodian has experience with regard to foreign custody services."

C. Applying Existing Rule 17f-5(c) to Compulsory Depositories Would Be Untenable.

The obstacles to foreign investment that would arise if Rule 17f-5(c) were applied to compulsory depositories also argue in favor of the Association's interpretation. As now written, the criteria in Rule 17f-5(c) are not well-suited to the analysis of compulsory depositories. Therefore, no party -- whether the fund board, the investment adviser, or the global custodian -- could meaningfully evaluate compulsory depositories under that framework. For example --

- The factors to be considered include "without limitation" the information set forth in Rule 17f-5(c)(1)(i)-(iv). Available information concerning most compulsory depositories is, however, limited, and the literal application of this requirement would be problematic in many cases.

- Many compulsory depositories are government instrumentalities, and requests for access to their internal systems and procedures may be viewed as an infringement on the prerogatives of the sovereign.

- Often, a compulsory depository is the only facility that handles particular securities. Therefore, no comparable entity exists in the market against which to measure the reasonableness of the compulsory depository's care.

- Rule 17f-5(c)(2) requires that custody arrangements be governed by specified protections, or by alternative provisions that afford the same or a greater level of care. If applicable to compulsory depositories, the need to make such a finding would prevent investment in the markets served by many of these facilities. Moreover, this problem would often be impossible to cure, since the standardized terms on which a compulsory depository deals with its participants are seldom negotiable.

For these reasons, neither fund boards nor their delegates should be asked to evaluate compulsory depositories under the existing criteria of Rule 17f-5(c). Any inability to make the required findings would preclude investment in the country involved and require that assets already held there be withdrawn. See Rule 17f-5(c)(3)(ii). If the Staff were to conclude -- contrary to our view -- that compulsory depositories are somehow subject to selection under Rule 17f-5(c), we would urge that the Staff modify the rule to create a more practical framework for the evaluation of

compulsory depositories. The Association and its members would, of course, ask to be active participants in that process.

Conclusion

We believe that investment company boards, advisers, and global custodians should have a common interest in solving the problem of how best to apply new Rule 17f-5 to compulsory depositories. In our view, the approach we have suggested would permit boards, advisers, and banks to perform the functions for which each is best qualified. It would also require that consideration be given to the safety of assets held in compulsory depositories, while at the same time recognizing that use of such a depository cannot be separated from the decision to invest in a security the depository handles.

We appreciate the Staff's consideration of this request. If you or your colleagues have questions concerning this letter or require any additional information, please contact the undersigned at 202/452-7013. We also ask that, if the Staff is inclined to issue an interpretation that is contrary to the views expressed in this letter, we first have the opportunity to meet with the Staff and discuss the matter.

Sincerely,

Daniel L. Goelzer

cc: Barry Barbash, Director
Division of Investment Management

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INVESTMENT COMPANY INSTITUTE

November 24, 1997

Investment Company Act of 1940/Rule 17f-5

Mr. Douglas J. Scheidt
Chief Counsel
Division of Investment Management
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Stop 10-6
Washington, D.C. 20549

Re: Compulsory Securities Depositories under Amended Rule 17f-5

Dear Mr. Scheidt:

The Investment Company Institute[1] is submitting this letter to request the Division of Investment Management staff's views regarding the treatment of compulsory securities depositories under Rule 17f-5 under the Investment Company Act of 1940, as recently amended by the Securities and Exchange Commission.[2] In our view, Rule 17f-5 permits the board of directors of any investment company to delegate to a U.S. bank or qualified foreign bank (hereinafter referred to as "custodian bank") the responsibilities set forth in Rule 17f-5(c) with respect to any compulsory securities depository.[3] We request the staff to confirm this interpretation of Rule 17f-5.

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,703 open-end investment companies ("mutual funds"), 441 closed-end investment companies and 10 sponsors of unit investment trusts. Its mutual fund members have assets of about $4.33 trillion, accounting for approximately 95% of total industry assets, and have over 59 million individual shareholders.

[2] See Investment Company Act Release No. 22658 (May 12, 1997) ("Adopting Release"). The Commission proposed amendments to Rule 17f-5 in Investment Company Act Release No. 21259 (July 27, 1995).

[3] For the purposes of this letter, we are using the term compulsory securities depository to mean a securities depository or clearing agency that is incorporated or organized under the laws of a country other than the United States and that acts as a system for the central handling of securities or equivalent book-entries in the country that is regulated by a foreign financial regulatory authority the use of which is mandatory: (i) by law or regulation; (ii) because securities cannot be withdrawn from such securities depository or clearing agency; or (iii) because maintaining securities outside the securities depository or clearing agency is not consistent with prevailing custodial practices. We recognize that the Commission did not adopt a definition of compulsory securities depository. Terminology substantially similar to that described above has been used by several custodian banks.

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Background

Investment companies currently are in the process of changing their foreign custodial arrangements so as to comply with amended Rule 17f-5.[4] A fundamental part of this process involves negotiating new foreign custodial contracts with several custodian banks. We have been informed that virtually all of the contracts provided by the custodian banks that currently are negotiating with investment companies uniformly define the term "compulsory securities depository" and that virtually all of these banks have refused to accept the responsibilities described in Rule 17f-5(c) with respect to compulsory securities depositories, including finding that an investment company's assets will be subject to reasonable care, based on the standards applicable to custodians in the relevant market. This position seems to be based on the belief that the Commission has concluded that the evaluation of compulsory securities depositories may not be delegated to custodian banks.[5]

Analysis

Rule 17f-5 clearly provides that the board of directors of any investment company may delegate to a custodian bank the responsibilities set forth in Rule 17f-5(c) with respect to any compulsory securities depository. The Commission specifically amended Rule 17f-5 to permit an investment company's board of directors to delegate to, among others, a custodian bank: (i) the selection of eligible foreign custodians that will provide reasonable care for fund assets; (ii) the determination that the fund's foreign custody arrangements are governed, in the case of a securities depository, by contract, by the rules or established practices or procedures of the depository, or by any combination of the foregoing that will provide reasonable care for fund assets; and (iii) the establishment of a system to monitor the appropriateness of maintaining the fund's assets with a custodian.[6] The Commission defined "eligible foreign custodian," to include securities depositories[7] and did not distinguish compulsory securities depositories[8] from any other securities depository, thereby permitting fund directors to delegate to a

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[4] Funds with established foreign custodial arrangements prior to the rule amendments' effective date are required to bring these arrangements into compliance with the amended rule within one year of the effective date of the amendments (which is June 16, 1998). (This would include adding a subcustodian to a fund complex's custodial arrangements or having a fund begin to maintain its assets under the fund complex's custodial arrangements.)

[5] The fact that, to our knowledge, virtually all custodian banks have taken this position appears to indicate that it is based upon an interpretation of the rule, rather than business considerations.

[6] See Rule 17f-5(b) (providing that a fund's board may delegate to a custodian bank the responsibilities set forth in Rule 17f-5(c)).

[7] Rule 17f-5(a)(1)(ii) defines an eligible foreign custodian to include, among other entities, "a securities depository ... that acts as a system for the central handling of securities or equivalent book-entries in the country that is regulated by a foreign financial regulatory authority... ." Rule 17f-5(a)(6) further defines securities depository as "a system for the central handling of securities as defined in §270.17f-4(a)." Rule 17f-4(a) defines securities depository as "a system for the central handling of securities where all securities of any particular class or series of any issuer deposited within the system are treated as fungible and may be transferred or pledged by bookkeeping entry without physical delivery of securities."

[8] As stated earlier, the Commission did not adopt a definition of compulsory securities depository.

custodian bank these responsibilities with respect to fund assets maintained in compulsory securities depositories. Indeed, the Adopting Release explicitly states that "the Commission has concluded that it is *not* necessary for the rule to distinguish between compulsory depositories and other types of foreign custodians."[9]

The Institute believes that permitting a fund board to delegate to its custodian bank the duty to assess the risk that a compulsory securities depository will not exercise the appropriate level of care with regard to fund assets is supported not only by the clear language of the rule and the Adopting Release, but also by common sense. As the Commission has recognized, safekeeping of fund assets typically is effected through a fund's global custodian, which uses a network of local subcustodians with which it has established relationships.[10] These local subcustodians typically are members of depositories and have access to information about the depository that would not be available to other persons (such as investment advisers). Because of their extensive experience with custodial matters, custodian banks also have the greatest expertise in evaluating the information received regarding a compulsory securities depository.

Precluding custodian banks from assuming these responsibilities likely would force fund advisers to assume these responsibilities, including conducting due diligence of compulsory securities depositories in countries throughout the world, thus duplicating the policies, procedures, and infrastructures that custodian banks currently have in place. This may entail great expense that ultimately would be borne by fund shareholders.

Alternatively, investment advisers could continue to rely on custodians to provide detailed information about compulsory securities depositories with the adviser making the determination that fund assets would be subject to reasonable care. Such an approach would be at odds with the Commission's stated goal of providing the board with the flexibility to delegate foreign custody decisions to the entity with the requisite expertise.[11] It seems at the very least inefficient that the party actually performing the due diligence with respect to the ability of the depository to provide reasonable care for fund assets would refuse to reach a conclusion in that regard.

Conclusion

For all of the above reasons, we respectfully request the staff's confirmation that Rule 17f-5 permits the board of directors of any investment company to delegate to a custodian bank the responsibilities set forth in Rule 17f-5(c) with respect to any compulsory securities

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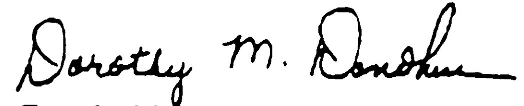
[9] Adopting Release at note 29 (emphasis added). It is important to emphasize that in carrying out these responsibilities, a custodian bank would not be held strictly liable for any loss of fund assets. Rather, the Commission made clear that Rule 17f-5 requires a delegate to exercise reasonable care in performing the delegated duties and that reasonable care, in this context, requires the delegate to exercise the care, prudence and diligence that a person having the responsibility for the safekeeping of fund assets would exercise. *See, e.g.*, Rule 17f-5(b)(3). The Commission also made clear that the determination that funds will be subject to reasonable care will be based on standards applicable to custodians in the relevant market. *See e.g.*, Rule 17f-5(c)(1).

[10] Adopting Release at 10-11.

[11] *See, e.g.*, Adopting Release at 14.

depository. We respectfully ask that if the staff intends to deny our request, you first provide us with an opportunity to meet to discuss the issues raised by this request. If you have any questions or require any additional information, you can contact me at 202/326-5821.

Very truly yours,



Dorothy M. Donohue
Associate Counsel

cc: Barry P. Barbash, Director
Division of Investment Management