

June 30, 1998

Barry P. Barbash
Director
Division of Investment Management
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Stop 5-6
Washington, D.C. 20549

Re: Evaluation of Depositories under Amended Rule 17f-5

Dear Mr. Barbash:

The Investment Company Institute¹ and the Association of Global Custodians² are submitting for your consideration a package of proposed amendments to Rule 17f-5 under the Investment Company Act of 1940 with respect to the evaluation of depositories.³ We believe that these amendments are necessary because it has become apparent that it is not possible for U.S. banks, qualified foreign banks ("custodian banks"), fund boards, or investment advisers to meaningfully evaluate depositories under the criteria currently set forth in Rule 17f-5(c).⁴ Because of the problems identified

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,091 open-end investment companies ("mutual funds"), 437 closed-end investment companies and 9 sponsors of unit investment trusts. Its mutual fund members have assets of about \$4.989 trillion, accounting for approximately 95% of total industry assets, and have over 62 million individual shareholders.

² The Association is an informal group of ten U.S. banks that are major providers of global custody services to U.S. mutual funds.

³ The Securities and Exchange Commission suspended the compliance date for amendments to Rule 17f-5 in order to consider this proposal. Although compliance was suspended until February 1, 1999, this date may need to be revisited depending upon the date the Commission adopts amendments to the rule or determines not to take any further action with respect to the rule.

⁴ See Letter from Daniel L. Goelzer, Baker & McKenzie, on behalf of the Association of Custodian Banks, to Douglas J. Scheidt, Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission ("SEC"), dated December 11, 1997 (...neither fund boards, investment advisers, or global custodians can meaningfully evaluate compulsory depositories under 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the required findings would preclude investment in the country involved and require that assets already held there be withdrawn.); Letter from Dorothy M. Donohue, Associate Counsel, Investment Company Institute to Douglas J. Scheidt, Chief Counsel, Division of Investment Management, SEC, dated November 24, 1997 (...virtually all custodian banks have refused to accept the responsibilities described in rule 17f-5(c) with respect to compulsory depositories.) Despite the SEC staff's issuance of a letter confirming that Rule 17f-5 permits the board of directors of any investment company to delegate to custodian banks the responsibilities set forth in Rule 17f-5(c) with respect to any compulsory depository, investment company representatives report that virtually all custodian banks are unwilling to accept such a delegation under the current terms of the rule.

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with the rule, most funds have not yet brought existing custodial arrangements into compliance with the amended rule.⁵

The proposed amendments would provide that the Foreign Custody Manager's ("FCM's") duty to make a reasonable care determination with respect to a depository would be deemed to be satisfied if the FCM determines that the depository in question meets a set of eight objective criteria. These criteria are designed to ensure that the depository satisfies certain minimum safekeeping standards. We believe that the criteria will provide adequate protection for fund assets, while at the same time providing a more meaningful and realistic standard by which to evaluate depositories.⁶

Both the Association and the Institute believe that, if the Commission were to revise Rule 17f-5 in the manner we are suggesting, it would greatly facilitate the delegation of responsibility from fund boards to other potential FCMs, such as U.S. banks. Each custodian bank and its fund clients are, of course, free to determine how to structure their relationship. However, if the proposal is adopted, we anticipate that global custodian banks would generally be willing to accept delegation to make the determinations under proposed Rule 17f-5(c)(2) and to maintain assets with depositories that meet this criteria.

A. Depository Standard of Care

As the Commission staff itself has noted, the application of Rule 17f-5's current selection criteria to compulsory depositories raises several issues for investment company boards, investment advisers, and custodian banks.⁷ The same problems arise in applying these criteria to noncompulsory depositories.⁸ While the information that an FCM is required to evaluate under the current selection criteria is appropriate with respect to foreign subcustodian banks, that information is frequently unavailable or irrelevant with respect to depositories. In addition, there are inherent difficulties in reaching a subjective or qualitative reasonable care determination with respect to a

⁵ Of 793 investment companies with over \$1.2 trillion in assets surveyed by the Institute, only 83 funds (or 10%) have entered into custodial arrangements that comply with amended Rule 17f-5.

⁶ We have attached an appendix prepared by members of the Association that addresses both of these points.

⁷ See Letter to Dorothy M. Donohue, Associate Counsel, Investment Company Institute, and Daniel L. Goelzer, Baker & McKenzie, from Robert E. Plaze, Associate Director, Division of Investment Management (Feb. 19, 1998).

⁸ At present, Rule 17f-5 does not distinguish between compulsory and noncompulsory depositories. We recommend that the Commission continue that approach. Developing a workable standard for determining when a depository is compulsory would likely result in the need for the staff to address interpretive issues with respect to specific depositories. Moreover, as noted above, we believe that the criteria we are proposing are of general applicability to all depositories.

depository. Depositories are often governmental or quasi-governmental entities with which it is seldom possible for a depositor to negotiate the terms and conditions under which assets are held. Because of this, we believe that objective criteria, rather than the more subjective standards applicable to subcustodian banks, are more appropriate for the evaluation of depositories. Under this approach, if a depository satisfies the specified objective criteria, fund assets held by that depository would be deemed subject to reasonable care.

We believe that the conditions in the proposed amendments would provide assurance that a depository will afford adequate protection. To satisfy these conditions, a depository would, for example, be required to segregate fund assets from the depository's own assets, to maintain records identifying a fund's assets, to provide periodic reports with respect to the safekeeping of fund assets held at the depository, including notification of any transfer to or from a fund's account, and to be subject to periodic review, such as audits by independent accountants or inspections by regulatory authorities. In addition, a depository would have to be regulated by a foreign financial regulatory authority, and the FCM would be required to determine that no regulatory authority has made a public finding of non-compliance with the applicable financial strength or internal control requirements. We believe that these factors, several of which are similar in concept to those in Rule 17f-4 under the Investment Company Act, focus on the fundamental protections that should be provided by a depository.

B. Foreign Custody Contract Provisions

The proposed amendments also would clarify that Rule 17f-5 requires a fund's foreign custody arrangements with any qualified foreign bank or a majority-owned direct or indirect subsidiary of a U.S. bank or bank holding company to be governed by a written contract containing the specified provisions (or such provisions that contain the same or a greater level of protection for fund assets). Under the proposed amendments, there would not be an additional requirement that a securities depository's practices or procedures also contain the specified provisions.* We believe that this additional requirement is unnecessary because Rule 17f-5(c)(2)'s requirement of reasonable care already provides adequate protection for fund assets held in a securities depository. In particular, the factors supporting a finding of reasonable care for depositories express the relevant conditions in terms that, unlike the contractual provisions, clearly can be applied to depositories.

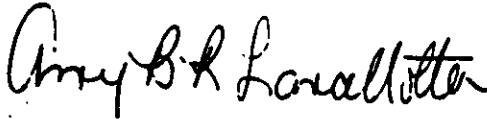
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* This approach would be consistent with current custody practices and a long-standing staff position. See Investment Company Institute (Oct. 29, 1987).

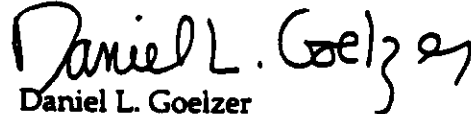
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We would be pleased to discuss our proposal with you in greater detail at your convenience. If you have any questions or would like additional information regarding the proposal, please contact Amy Lancellotta at 202/326-5824, Dorothy Donohue at 202/326-5821, or Daniel Goelzer at 202/452-7013.

Sincerely,



Amy B. R. Lancellotta, Senior Counsel
Investment Company Institute



Daniel L. Goelzer
Baker & McKenzie
on behalf of the
Association of Global Custodians

Enclosures:

Text of Proposed Amendments to Rule 17f-5
Evaluation of Depositories under Amended Rule 17f-5

cc: **Robert E. Plaze**
Associate Director
Division of Investment Management

C. Hunter Jones, Assistant Director
Office of Regulatory Policy
Division of Investment Management

Text of Proposed Amendments to Rule 17f-5
Investment Company Institute/Association of Global Custodians Submission
June 30, 1998

Section 270.17f-5 is revised to read as follows: (Underlined text shows additions to Rule 17f-5. Bracketed language shows deletions from the rule.)

§270.17f-5. Custody of investment company assets outside the United States.

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

(1) *Eligible Foreign Custodian* means an entity that is incorporated or organized under the laws of a country other than the United States and that is:

(i) A Qualified Foreign Bank or a majority-owned direct or indirect subsidiary of a U.S. Bank or bank-holding company;

(ii) A securities depository or clearing agency 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 as defined under section 2(a)(50) of the Act [15 U.S.C. 80a-2(a)(50)]; or

(iii) A securities depository or clearing agency that acts as a transnational system for the central handling of securities or equivalent book-entries.

(2) *Foreign Custody Manager* means a Fund's or a Registered Canadian Fund's board of directors or any person serving as the board's delegate under paragraphs (b) or (d) of this section.

(3) *Fund* means a management investment company registered under the Act [15 U.S.C. 80a] and incorporated or organized under the laws of the United States or of a state.

(4) *Qualified Foreign Bank* means a banking institution or trust company, incorporated or organized under the laws of a country other than the United States, that is regulated as such by the country's government or an agency of the country's government.

(5) *Registered Canadian Fund* means a management investment company incorporated or organized under the laws of Canada and registered under the Act pursuant to the conditions of §270.7d-1.

(6) *Securities Depository* means a system for the central handling of securities as defined in §270.17f-4(a).

(7) *U.S. Bank* means an entity that is:

(i) A banking institution organized under the laws of the United States;

(ii) A member bank of the Federal Reserve System;

(iii) Any other banking institution or trust company organized under the laws of any state or of the United States, whether incorporated or not, doing business under the laws of any state or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this section, or

(iv) A receiver, conservator, or other liquidating agent of any institution or firm included in paragraphs (a)[(7)(8)(i), (ii), or (iii)] of this section.

(b) *Delegation*. A Fund's board of directors may delegate to the Fund's investment adviser or officers or to a U.S. Bank or to a Qualified Foreign Bank the responsibilities set forth in paragraphs (c)[(1), (c)(2), or (c)(3)] (d), or (e) of this section, *provided that*:

(1) The board determines that it is reasonable to rely on the delegate to perform the delegated responsibilities;

(2) The board requires the delegate to provide written reports notifying the board of the placement of the Fund's assets with a particular custodian and of any material change in the

Fund's arrangements, with the reports to be provided to the board at such times as the board deems reasonable and appropriate based on the circumstances of the Fund's foreign custody arrangements; and

(3) The delegate agrees to exercise reasonable care, prudence and diligence such as a person having responsibility for the safekeeping of Fund assets would exercise, or to adhere to a higher standard of care, in performing the delegated responsibilities.

(c) **[Selecting an Eligible Foreign Custodian] Use of Eligible Foreign Custodians.** A Fund may place and maintain in the care of an Eligible Foreign Custodian any investments (including foreign currencies) for which the primary market is outside the United States, and such cash and cash equivalents as are reasonably necessary to effect the Fund's transactions in such investments, *provided that* [(1) the Foreign Custody Manager determines that] the Fund's assets will be subject to reasonable care as provided in paragraphs (1), (2), or (3) below.

(1) With respect to any Eligible Foreign Custodian (other than a Securities Depository), the Foreign Custody Manager shall determine that the Fund's assets will be subject to reasonable care based on the standards applicable to custodians in the relevant market, if maintained with the Eligible Foreign Custodian [custodian], after considering all factors relevant to the safekeeping of such assets, including, without limitation:

(i) The custodian's practices, procedures, and internal controls, including, but not limited to, the physical protections available for certificated securities (if applicable), the method of keeping custodial records, and the security and data protection practices;

(ii) Whether the custodian has the requisite financial strength to provide reasonable care for Fund assets;

(iii) The custodian's general reputation and standing [and, in the case of a Securities Depository the depository's operating history and number of participants]; and

(iv) Whether the Fund will have jurisdiction over and be able to enforce judgments against the custodian, such as by virtue of the existence of any offices of the custodian in the United States or the custodian's consent to service of process in the United States.

(2) Fund assets placed and maintained in the care of any Securities Depository will be deemed to be subject to reasonable care if the Foreign Custody Manager determines that:

(i) an Eligible Foreign Custodian as defined in paragraph (a)(1)(i) or a U.S. bank holding assets at the Securities Depository on behalf of the Fund undertakes to adhere to the rules, practices, and procedures of the Securities Depository;

(ii) no regulatory authority with oversight responsibility for the Securities Depository has issued a public notice that the depository is not in compliance with any material capital, solvency, insurance, or other similar financial strength requirements imposed by such authority, or, in the case of such a notice having been issued, that such notice has been withdrawn or the remedy of such noncompliance has been publicly announced by the depository;

(iii) no regulatory authority with oversight responsibility over the Securities Depository has issued a public notice that the depository is not in compliance with any material internal controls requirement imposed by such authority, or, in the case of such notice having been issued, that such notice has been withdrawn or the remedy of such noncompliance has been publicly announced by the depository;

(iv) the Securities Depository maintains the assets of the Fund's depositor under no less favorable safekeeping conditions than those that apply generally to depositors;

(v) the Securities Depository maintains records that segregate the Securities Depository's own assets from the assets of depositors;

(vi) the Securities Depository maintains records that identify the assets of each of its depositors;

(vii) the Securities Depository provides periodic reports to its depositors with respect to the safekeeping of assets maintained by the Securities Depository, including, but not limited to, notification of any transfer to or from a depositor's account; and

(viii) the Securities Depository is subject to periodic review, such as audits by independent accountants or inspections by regulatory authorities.

(3) Notwithstanding the foregoing, Fund assets placed and maintained in the care of a Securities Depository that does not meet any or all of the conditions specified in paragraph (c)(2) will be deemed to be subject to reasonable care if the Foreign Custody Manager determines that the Securities Depository meets such other criteria that will provide, in their entirety, the same or a greater level of protection for Fund assets as the conditions specified in paragraph (c)(2) above, in their entirety.

[2] (d) Contract. The Fund's foreign custody arrangements with an Eligible Foreign Custodian (other than a Securities Depository) [(or in the case of a Securities Depository, by such a contract, by the rules or established practices or procedures of the depository, or by any combination of the foregoing)] must be governed by a written contract that the Foreign Custody Manager has determined will provide reasonable care for Fund assets based on the standards specified in paragraph (c)(1) of this section.

[(i)] (1) Such contract shall include provisions that provide:

[(A)] (i) For indemnification or insurance arrangements (or any combination of the foregoing) such that the Fund will be adequately protected against the risk of loss of assets held in accordance with such contract;

[(B)] (ii) That the Fund's assets will not be subject to any right, charge, security interest, lien or claim of any kind in favor of the custodian or its creditors except a claim of payment for their safe custody or administration or, in the case of cash deposits, liens or rights in favor of creditors of the custodian arising under bankruptcy, insolvency, or similar laws;

[(C)] (iii) That beneficial ownership for the Fund's assets will be freely transferable without payment of money or value other than for safe custody or administration;

[(D)] (iv) That adequate records will be maintained identifying the assets as belonging to the Fund or as being held by a third party for the benefit of the Fund;

[(E)] (v) That the Fund's independent public accountants will be given access to those records or confirmation of the contents of those records; and

[(F)] (vi) That the Fund will receive periodic reports with respect to the safekeeping of the Fund's assets, including, but not limited to, notification of any transfer to or from the Fund's account or a third party account containing assets held for the benefit of the Fund.

[(ii)] (2) Such contract may contain, in lieu of any or all of the provisions specified in paragraph (i), such other provisions that the Foreign Custody Manager determines will provide, in their entirety, the same or a greater level of care and protection for Fund assets as the specified provisions, in their entirety.

[(3)(i)] (e)(1) *Monitoring the Foreign Custody Arrangements.* The Foreign Custody Manager must have established a system to monitor the appropriateness of maintaining the Fund's assets with a particular Eligible Foreign Custodian [custodian] in accordance with the requirements of paragraphs (c)(1), (c)(2), or (c)(3) of this section , as appropriate, and the contract governing the Fund's arrangements under paragraph [(c)(2)](d) of this section.

[(ii)] (2) If an arrangement no longer meets the requirements of this section, the Fund must withdraw its assets from the Eligible Foreign Custodian [custodian] as soon as reasonably practicable.

[(d)] (f) *Registered Canadian Funds.* Any Registered Canadian Fund may place and maintain outside the United States any investments (including foreign currencies) for which the primary market is outside the United States, and such cash and cash equivalents as are reasonably necessary to effect the Fund's transactions in such investments, in accordance with the requirements of this section, *provided that:*

(1) The assets are placed in the care of an overseas branch of a U.S. Bank that has aggregate capital, surplus, and undivided profits of a specified amount, which must not be less than \$500,000; and

(2) The Foreign Custody Manager is the fund's board of directors, its investment adviser or officers, or a U.S. Bank.