

INVESTMENT COMPANY INSTITUTE * ASSOCIATION OF GLOBAL CUSTODIANS

February 26, 1999

BY MESSENGER

Paul F. Roye
Director, Division of Investment Management
Securities and Exchange Commission
Mail Stop 5-6
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Mr. Roye:

During your meetings on January 12, 1999 with representatives of the Investment Company Institute ("Institute") and of the Association of Global Custodians ("Association"), the staff raised several questions regarding the joint proposal to amend Rule 17f-5 submitted to the Commission on June 30, 1998 ("Joint Proposal") by the Institute and the Association. The staff invited us to modify that proposal in light of the discussions on January 12.

We have prepared a revised version of the Joint Proposal which, in the view of the Association and the Institute, addresses the staff's concerns. Enclosed are the following documents --

- (1) A copy of Rule 17f-5, marked to show the changes to the current rule that we propose.
- (2) A copy of the Joint Proposal (as submitted to the staff on June 30), marked to show the changes we have made to that proposal in light of the discussions at the January 12 meetings.
- (3) A brief paper explaining the revisions we have made to the Joint Proposal.

We believe that the Joint Proposal, with the revisions we have made in light of our discussions with the staff, would create a workable framework for the evaluation of foreign securities depositories under Rule 17f-5. Our proposal also would permit those fund boards that wish to do so to delegate Foreign Custody Manager responsibilities with respect to depositories in accord

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Director, Division of Investment Management
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with Rule 17f-5(b). We also believe that the approach we suggest is fully consistent with the Commission's responsibilities under Section 17(f) of the Investment Company Act.

We would be pleased to discuss our revised proposal with you or with members of your staff in greater detail at your convenience. If you have any questions, or would like additional information regarding the revised proposal, please contact Amy Lancellotta at 202/326-5824 or Daniel L. 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:

- (1) Comparison of February 26, 1999 Proposal to Rule 17f-5
- (2) Comparison of February 26, 1999 Proposal to June 30, 1998 Proposal
- (3) Explanation of Proposed Modifications to Proposal To Amend Rule 17f-5 (February 26, 1999)

cc: Robert E. Plaze
Associate Director

C. Hunter Jones
Assistant Director
Office of Regulatory Policy

Thomas M.J. Kerwin
Office of Regulatory Policy

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Associate Director

C. Hunter Jones
Assistant Director
Office of Regulatory Policy

Thomas M.J. Kerwin
Office of Regulatory Policy

COMPARISON OF REVISED JOINT PROPOSAL TO RULE 17F-5

Additions to Rule 17f-5 that would result from the Investment Company Institute/Association of Global Custodians revised joint proposal to amend the rule are in boldface type and underscored; deletions are [in boldface type and brackets].

§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)]~~ **(f)** 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)(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 delegates 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 custodian 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[.];

provided, however, that Fund assets placed or maintained in the care of any Securities Depository will not be deemed to be subject to reasonable care if information actually known to the Foreign Custody Manager (after review consistent with the standard of care applicable to delegates under paragraph (b)(3)) establishes that the Securities Depository is

not in compliance with any material capital, solvency, insurance or other similar financial strength requirements imposed by a regulatory authority with oversight responsibility for the Securities Depository, or that the Securities Depository is not in compliance with any material internal controls requirement imposed by such authority.

(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)** must be governed by a written contract [(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)] 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, **if applicable**, the contract governing the Fund's arrangements under paragraph [(c)(2)](d) of this section. **In the case of assets maintained with an Eligible Foreign Custodian that is a Securities Depository, such system shall also monitor whether any material change in the**

Fund's custody arrangements with such Securities Depository has occurred, regardless of whether such change is related to the factors in paragraph (c)(2)(i) through (viii) 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 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 officer, or a U.S. Bank.

COMPARISON OF FEBRUARY 26, 1999 PROPOSAL TO JUNE 30, 1998 PROPOSAL

Additions to the June 30, 1998 Investment Company Institute/Association of Global Custodians joint proposal to amend Rule 17f-5 are **in boldface type and underscored**; deletions are [in boldface type and brackets]. "NO CHANGE" indicates no change in the paragraph identified since the June 30, 1998 proposal.

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

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

(1) NO CHANGE.

(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)]~~ **(f)** of this section.

(3) - (7) NO CHANGE.

(b) *Delegation.*

NO CHANGE.

(c) *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* the Fund's assets will be subject to reasonable care as provided in paragraphs (1), (2), or (3) below.

(1) NO CHANGE.

(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[.];

provided, however, that Fund assets placed or maintained in the care of any Securities Depository will not be deemed to be subject to reasonable care if information actually known to the Foreign Custody Manager (after review consistent with the standard of care applicable to delegates under paragraph (b)(3)) establishes that the Securities Depository is not in compliance with any material capital, solvency, insurance or other similar financial strength requirements imposed by a regulatory authority with oversight responsibility for the Securities Depository, or that the Securities Depository is not in compliance with any material internal controls requirement imposed by such authority.

(3) NO CHANGE.

(d) *Contract.*

NO CHANGE.

(e) *Monitoring the Foreign Custody Arrangements.*

(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 in accordance with the requirements of paragraphs (c)(1), (c)(2), or (c)(3) of this section , as appropriate, and, **if applicable**, the contract governing the Fund's arrangements under paragraph (d) of this section. **In the case of assets maintained with an Eligible Foreign Custodian that is a Securities Depository, such system shall also monitor whether any material change in the Fund's custody arrangements with such**

Securities Depository has occurred, regardless of whether such change is related to the factors in paragraph (c)(2)(i) through (viii) of this section.

(2) NO CHANGE.

(f) *Registered Canadian Funds.*

NO CHANGE.

Explanation of Proposed Modifications to Proposal
To Amend Rule 17f-5

February 26, 1999

During meetings on January 12, 1999 with representatives of the Investment Company Institute ("ICI") and of the Association of Global Custodians ("AGC"), the staff raised several concerns regarding the joint proposal to amend Rule 17f-5 submitted to the Commission on June 30, 1998 ("Joint Proposal") by the ICI and the AGC. The AGC and the ICI have modified the Joint Proposal to address those concerns, and this paper provides a brief explanation of the modifications.

1. Catch-all Evaluation Factor

In fashioning the Joint Proposal, we sought to develop an objective test that Foreign Custody Managers could apply in determining whether a foreign securities depository provides reasonable care to deposited assets. That test, which consists of eight factors, appears in proposed Rule 17f-5(c)(2).

The staff expressed a concern during the January 12 meetings that the proposed test could create an anomalous situation in which a depository might be deemed to provide reasonable care under the eight factors, notwithstanding that the Foreign Custody Manager ("FCM") had actual knowledge that the depository was materially unsafe or out of compliance with local regulatory requirements. The staff suggested that some type of catch-all factor be added to the proposed test in order to address this possibility.

In response, we have added a proviso to proposed Rule 17f-5(c)(2) following the eight factors. This proviso states:

provided, however, that Fund assets placed or maintained in the care of any Securities Depository will not be deemed to be subject to reasonable care if information actually known to the Foreign Custody Manager (after review consistent with the standard of care applicable to delegates under paragraph (b)(3)) establishes that the Securities Depository is not in compliance with any material capital, solvency, insurance or other similar financial strength requirements imposed by a regulatory authority with oversight responsibility for the Securities Depository, or that the Securities Depository is not in compliance with any material internal controls requirement imposed by such authority.

This modification would make clear that the Foreign Custody Manager must consider known information that indicates that the depository is not in compliance with basic safe-keeping standards

applicable in the relevant market. We believe that this change fully addresses the staff's concerns for the following reasons:

- Financial strength and internal control requirements. The proviso focuses on financial strength and internal control requirements. Compliance with requirements in these areas is key to depository safety. Further, as the rule already recognizes, the appropriate test of a subcustodian's ability to afford reasonable care is local market standards and requirements. This is particularly true in the case of depositories -- which are generally unique institutions in their jurisdiction.
- FCM diligence. The proviso recognizes that FCMs must review the depository before making a determination under Rule 17f-5(c)(2). Because circumstances vary widely from market to market, it is not feasible to prescribe in detail what that review should entail. Instead, the proviso incorporates the standard of care to which FCMs are already subject under Rule 17f-5(b)(3) -- "reasonable care, prudence and diligence such as a person having responsibility for the safekeeping of fund assets would exercise."¹
- FCM knowledge. In light of the duty to conduct a review consistent with Rule 17f-5(b)(3), and because detailed information concerning the depository will have to be gathered in order to make findings concerning the eight factors, the FCM will necessarily have considerable information concerning the depository. Therefore, an FCM could not take a "head-in-the-sand" approach to depository evaluation. For this reason, we believe that an actual knowledge standard is appropriate in the context of the proviso.

¹/ A higher standard of care would apply if the Foreign Custody Manager is a delegate and has agreed to that higher standard in its contract with the fund. If the fund board is acting as FCM, there would be no delegation contract, and the board would be required to conduct its review consistent with the "reasonable care, prudence and diligence" standard. That standard is generally consistent with the fiduciary duty to which fund directors are typically subject under state law.

2. Obligation to Gather and Provide Information Concerning Depositories

Another point of discussion during the January 12 meetings was that global custodian banks (who are likely to be asked to assume delegated Foreign Custody Manager responsibilities in most cases) are in the best position to obtain information concerning depositories and to evaluate whether that information suggests that a change in custody conditions has occurred at the depository.² The staff expressed concern that the rule make clear that Foreign Custody Managers should gather and furnish such information on a continuous basis to their investment company clients.

As the Association representatives explained during their meeting, we believe that, for both business and contractual reasons, global custodians are already fulfilling this role. Global custodians recognize that their clients expect to be kept abreast of developments relating to foreign market financial infrastructure that could bear on the safety of assets held in the market. Providing this type of information is an important function of a global custodian.

Nonetheless, in response to the staff's comments on this issue, we have added an additional sentence to proposed Rule 17f-5(e)(1). Proposed paragraph (e)(1) sets forth the obligation of the FCM to monitor eligible foreign custodians with which fund assets have been placed. The new sentence, which would codify the monitoring obligation with respect to securities depositories, states:

In the case of assets maintained with an Eligible Foreign Custodian that is a Securities Depository, such system shall also monitor whether any material change in the Fund's custody arrangements with such Securities Depository has occurred, regardless of whether such change is related to the factors in paragraph (c)(2)(i) through (viii) of this section.

^{2/} This information could fall into either of two categories: Some material adverse changes may indicate that the depository no longer meets the reasonable care criteria in proposed Rule 17f-5(c)(2) (or alternative criteria applied under proposed Rule 17f-5(c)(3)). Other such changes, while not impacting on the reasonable care criteria, might affect the overall assessment of the risk of holding assets in the jurisdiction.

This modification would make clear that the Foreign Custody Manager must monitor both whether the initial reasonable care determination continues to be valid and whether there have been any other material changes in the depository's activities which, while not undermining reasonable care, might be germane to the evaluation of country risk.

This proposed depository monitoring provision should be read in light of Rule 17f-5(b)(2), which requires that the board impose a reporting obligation on delegates acting as FCMs. Rule 17f-5(b)(2) states that, in delegating FCM responsibilities, the board must require --

"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 * * * ." (emphasis added)

The new sentence in proposed Rule 17f-5(e)(1) is intended to make clear that material changes in depository arrangements are within the reporting obligation in paragraph (b)(2), even if those changes do not affect the reasonable care determination under Rule 17f-5(c). The addition to proposed paragraph (e)(1) also responds to the concern that global custodians acting as FCMs might not provide the same level of information concerning depositories to all of their clients.

3. Technical Changes

We have also made two technical changes to our June 30, 1998 proposal.

a. Monitoring of Contracts

The insertion of the words "if applicable" in the first sentence of proposed paragraph (e)(1) corrects a minor drafting error in the June 30 proposal. Under our proposal, the contract requirements would not apply to securities depositories, and therefore, in the case of depositories, there is no contract to monitor. The insertion of the words "if applicable" in paragraph (e)(1) makes this clear.

b. FCM Definition

We have also made a minor change to the definition of "Foreign Custody Manager" in Rule 17f-5(a)(2). This change merely conforms the cross-reference to the section of the proposed rule relating to Canadian registrants to the existing rule. The failure to include this change in the June 30, 1998 proposal was an oversight.

* * *

In reviewing our proposal, we would urge the staff to bear in mind that, even without the changes described above, a delegate, such as a global custodian, acting as a fund's Foreign Custody Manager, could not place or maintain assets with a securities depository based merely on a mechanical application of the eight objective factors or without regard to relevant, adverse information outside of the factors. Rule 17f-5(b)(3) requires that the delegate agree 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 delegated responsibilities."

This "reasonable care, prudence, and diligence" standard is applicable to all of the delegate's responsibilities, including application of the criteria for depository evaluation that would be established under our proposed Rule 17f-5(c)(2). Consistent with that standard, an FCM could not, in our view, place assets with a depository that it knew to be unsafe.