SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release Nos. IC–23815, IS–1194; File No. S7–15–99]

RIN 3235–AH55

Custody of Investment Company Assets Outside the United States

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Commission is proposing rule amendments and a new rule under the Investment Company Act to address the custody of investment company assets outside the United States. The amendments and new rule would establish new standards governing the maintenance of an investment company's assets with a foreign securities depository. The proposals are designed to provide a workable framework under which an investment company can protect its assets while maintaining them with a foreign securities depository.

DATES: Comments must be received on or before July 15, 1999.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, NW, Washington, DC 20549–0609. Comments also may be submitted electronically to the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7–15–99; this file number should be included on the subject line if E-mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 5th Street, NW, Washington, DC 20549. Electronically submitted comment letters will be posted on the Commission's Internet web site (http://www.sec.gov).

FOR FURTHER INFORMATION CONTACT: Thomas M.J. Kerwin, Senior Counsel, or C. Hunter Jones, Assistant Director, Office of Regulatory Policy, at (202) 942–0690, in the Division of Investment Management, Securities and Exchange Commission, 450 5th Street NW, Washington DC 20549–0506.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission (''Commission'') today is proposing for public comment amendments to rule 17f–5 (17 CFR 270.17f–5),[1] a new rule 17f–7, and conforming amendments to rule 7d–1 (17 CFR 270.7d–1) and rule 17f–4 (17 CFR 270.17f–4) under the Investment Company Act of 1940 (15 U.S.C. 80a) (the ''Investment Company Act''). In a companion release, the Commission also is extending the *compliance* date for previous amendments to rule 17f–5 (except for the amended definition of an ''eligible foreign custodian'') that were published on May 16, 1997 (62 FR 26923). The compliance date is extended from May 1, 1999 until May 1, 2000, or until a date to be announced by the Commission when it takes further action on the amendments proposed in this Release. *See* Investment Company Act Release No. 23814 (Apr. 29, 1999).

I. Executive Summary

Rule 17f–5 under the Investment Company Act governs the custody of the assets of registered management investment companies (''funds'') with custodians outside the United States. We amended the rule in 1997 to modernize its conditions, but later suspended the compliance date for some of the amendments after learning that they presented problems for the use of foreign securities depositories. Depositories are systems for the central handling of securities in which transactions in securities are processed through adjustment of electronic account records rather than delivery of certificates.

The Commission is proposing amendments to rule 17f–5 and a new rule 17f–7, which together would permit funds to maintain their assets in foreign securities depositories based on conditions that reflect the operations and role of these depositories. The amendments would eliminate for foreign depository arrangements the requirements that certain findings be made by the fund board, its investment adviser, or global custodian, and that certain specified terms appear in depository rules for participants. Instead, the proposed rule would establish basic standards for foreign depositories eligible to be used by funds, and generally require that a fund's contract with its global custodian obligate the custodian to provide the fund or its adviser with an initial risk analysis of the depository, continuously monitor risks associated with use of the depository, and notify the fund or its adviser of material changes in these risks. The global custodian also generally would have to agree to exercise reasonable care with respect to these and other duties.

Unlike rule 17f–5, proposed rule 17f–7 would not contain any provisions regarding the delegation of authority under the rule. Decisions to maintain assets with the depository should be made by the adviser, subject to the oversight of the fund board, based upon information provided by the global custodian. The adviser and board, in making these decisions, would be subject to the standards of care that are generally applicable to fund advisers and directors.

I. Introduction

Rule 17f–5 was initially adopted in 1984,[2] and extensively revised in 1997 (''1997 Amendments'') to reflect significant developments in foreign investment by U.S. funds and the Commission's greater experience with foreign custodial arrangements.[3] The 1997 Amendments expanded the types of foreign banks and securities depositories that may serve as custodians of fund assets by eliminating capital requirements and other restrictions that in some cases had precluded funds from using otherwise suitable custodians.[4] Instead, the 1997 Amendments require that the selection of a foreign custodian be based on whether the fund's assets will be subject to reasonable care if maintained with that custodian, after consideration of all factors relevant to the safekeeping of fund assets.[5]

The 1997 Amendments also eliminated from rule 17f–5 the consideration of ''prevailing country risks,'' *i.e.*, risks associated with investing in a particular country rather than placing assets with a particular custodian, as well as the consideration of other investment risks.[6] We made these changes after concluding that prevailing country risks were akin to investment risks, and that both should be considered by a fund's board or investment adviser when deciding whether the fund should invest in a

[1] Unless otherwise noted, all references to ''rule 17f–5'' or any paragraph of the rule will be to 17 CFR 270.17f–5.

[2] Section 17(f) of the Investment Company Act, which governs fund custody arrangements, does not address the use of a foreign custodian. The Commission adopted rule 17f–5 pursuant to its exemptive authority under section 6(c) of the Act. *See* Exemption for Custody of Investment Company Assets Outside the United States, Investment Company Act Release No. 14132 (Sept. 7, 1984) (49 FR 36080 (Sept. 14, 1984)) (the ''1984 Release'').

[3] *See* Custody of Investment Company Assets Outside the United States, Investment Company Act Release No. 22658 (May 12, 1997) (62 FR 26923 (May 16, 1997)) (the ''1997 Release'').

[4] 1997 Release, *supra* note 3, at text accompanying nn.71–73 and nn.77–79.

[5] *See* rule 17f–5(c)(1). These provisions replaced earlier standards under which the fund board had determined whether maintaining assets with a custodian would be ''consistent with the best interests'' of the fund. *See* 1997 Release, *supra* note 3, at n.6 and accompanying text.

[6] 1997 Release, *supra* note 3, at text accompanying nn.13–16 and at n.29.

particular country. Finally, the amendments permitted directors to play a more traditional oversight role by allowing them to delegate their duties under the rule to a ''foreign custody manager,'' which could include the fund's investment adviser, officers, or a bank.[7]

The 1997 Amendments altered the conditions under which funds could maintain their assets with foreign securities depositories as well as other types of foreign custodians. Throughout the rulemaking, the Commission made it clear that we considered foreign depositories to be custodians for purposes of the rule.[8] In response to comments on the proposals, the 1997 Amendments looked to depository rules for participants rather than custodial contracts to satisfy certain conditions of the rule.[9] Having addressed what we believed to be commenters' concerns regarding depositories, we established a one-year transition period to allow funds and bank custodians to enter into new custodial agreements, which would include the use of foreign depositories.[10]

By early 1998, it became apparent that the rule would not operate as anticipated. Bank custodians refused to accept delegated responsibility to make findings under the rule regarding funds' use of most foreign securities depositories.[11] Representatives of funds requested that we delay the compliance date for the 1997 Amendments to permit them to prepare a proposal to further amend the rule.[12] They asserted that many funds had been unable to establish foreign custody arrangements under the amendments because of significant unforeseen problems with the evaluation and use of most depositories. In particular, they stated that global bank custodians were unable to commit to making ''subjective'' determinations of whether foreign securities depositories would exercise reasonable care with fund assets.[13]

On May 21, 1998, we suspended the compliance date for most of the 1997 Amendments to allow time for representatives of funds and custodians to submit suggested amendments to rule 17f–5.[14] In June 1998, representatives of funds and representatives of bank custodians submitted a joint proposal to further amend the rule (''ICI/Bank Proposal'').[15] The ICI/Bank Proposal would deem fund assets maintained with a depository to be subject to reasonable care if eight objective criteria were met.[16] Depository rules would not have to contain provisions that rule 17f–5 generally requires to be included in custody contracts, including provisions for indemnification or insurance.[17]

The Commission has reviewed the ICI/Bank Proposal and related submissions, and is persuaded that the 1997 Amendments do not work well when applied to foreign securities depositories. Some contract provisions generally required by the amended rule to protect fund assets may not be feasible when applied to depository rules.[18] We are not persuaded, however, that the ICI/Bank Proposal provides a solution. We are concerned that a rule that relied only on limited objective criteria may not adequately identify the potential risks of depository arrangements in a changing global marketplace. We are particularly reluctant to implement a proposal that might unduly narrow the evaluation of potential risks, and reduce incentives to provide relevant information to funds.[19]

The Commission proposes to take a different approach in a proposed new rule with respect to foreign securities depositories. In doing so, we recognize that the establishment of depositories in countries around the world is generally a favorable development for funds and their shareholders. The use of depositories simplifies the clearance and settlement of securities transactions, and may eliminate some risks of loss, theft, and destruction of securities held in certificate form.[20] Depositories in many countries, however, are relatively new institutions, and their financial strength and operational capabilities vary. Only a limited group of intermediaries, including global custodians and local banks that participate directly in depositories, may have any contractual relationship with a depository or the ties needed to monitor risks associated with the use of the depository.

Our new approach can best be explained by reference to the regulatory discussion that preceded the 1997 Amendments. Those amendments distinguished between the ''custody risks'' of maintaining assets overseas, which must be addressed by a fund's foreign custody manager, and ''prevailing country risks,'' which no longer had to be considered under the rule because we believed they were more appropriately considered by a

[7] *See* rule 17f–5(b); 1997 Release, *supra* note 3, at text accompanying n.21.

[8] Custody of Investment Company Assets Outside the United States, Investment Company Act Release No. 21259 at n.71 and accompanying text (July 27, 1995) (60 FR 39592 (Aug. 2, 1995)); 1997 Release, *supra* note 3, at n.29 and accompanying text.

[9] 1997 Release, *supra* note 3, at nn.65–66 and accompanying text. In response to comments, we also did not adopt proposed amendments that would have treated the selection of some types of depositories differently from the selection of other types of foreign custodians. *Id.* at n.29.

[10] *Id.* at text following n.86.

[11] *See* Letter to Douglas J. Scheidt, Chief Counsel, Division of Investment Management, from Dorothy M. Donohue, Associate Counsel, Investment Company Institute (Nov. 24, 1997) (placed in File No. S7–15–99).

[12] *See* Letter to Barry P. Barbash, Director, Division of Investment Management, from Dorothy M. Donohue, Associate Counsel, Investment Company Institute (Mar. 24, 1998) (placed in File No. S7–15–99) (the ''March 1998 Letter'').

[13] *Id.* In general, representatives of funds and bank custodians have asserted that depositories provide a necessary service for which no feasible alternative may exist, that depository standards vary from one country to another, that information about quasi-sovereign depositories may be more difficult to obtain than information about other foreign custodians, and that inflexible depository rules may not accommodate the contract terms or equivalent protections required by the 1997 Amendments. *See id.*; Letter to Barry P. Barbash, Director, Division of Investment Management, from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute and Daniel L. Goelzer, Baker & McKenzie (June 30, 1998) (placed in File No. S7–15–99) (the ''June 1998 Letter'').

[14] *See* Custody of Investment Company Assets Outside the United States, Investment Company Act Release No. 23201 (May 21, 1998) (63 FR 29345 (May 29, 1998)). The compliance date for the amended definition of ''eligible foreign custodian'' remained June 16, 1998.

[15] *See* June 1998 Letter, *supra* note 13.

[16] The criteria would require that no foreign regulators have issued public statements indicating that the depository has not complied with financial strength or internal controls requirements (unless the problem has been cured); that the depository maintain certain safeguards such as segregating depository assets from participant assets, identifying assets in depository records, providing account reports to participants, and undergoing periodic review by auditors or regulators; and that the fund's custodian agree to comply with the depository's requirements. June 1998 Letter, *supra* note 13.

Representatives of funds and bank custodians submitted a revised proposal on February 26, 1999. *See* Letter to Paul F. Roye, Director, Division of Investment Management, from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute and Daniel L. Goelzer, Baker & McKenzie (Feb. 26, 1999) (placed in File No. S7–15–99) (the ''Revised ICI/Bank Proposal''). Under the Revised ICI/Bank Proposal, the foreign custody manager would consider information known to it if the information established certain compliance problems, even if foreign regulators had not yet acted. In addition, the foreign custody manager would have to monitor depository arrangements for any material changes.

[17] *See* rule 17f–5(c)(2)(i) and (ii) (requiring specified terms, or other provisions that provide equivalent protection, to appear in custody contract).

[18] *See* June 1998 Letter, *supra* note 13 (accompanying appendix suggests that contractual provisions for indemnification or insurance, no liens, free transferability of assets, and auditor access might be unworkable for depository custody). It is unclear whether other provisions might provide equivalent protection. *See* rule 17f–5(c)(2)(ii).

[19] We are also concerned that the terms of such a rule could be used to delimit responsibility under custodial contracts.

[20] *See* Uniform Commercial Code, Revised Article 8, Prefatory Note at I.C.; Randall D. Guynn, Modernizing Securities Ownership, Transfer and Pledging Laws 21 (Capital Markets Forum, International Bar Association 1996).

fund's adviser or board of directors as part of the decision to invest in the country.[21] A securities depository keeps asset ownership records that might be tampered with or destroyed, and the use of a depository thus exposes a fund to custody risks.[22] Yet a securities depository also may be an instrumentality of a foreign government or market and may operate under an exclusive license, making its use practically (and perhaps legally) necessary for a fund that wishes to invest in a particular foreign market. As a result, a custody decision not to use a foreign depository because of custody risks may effectively compel an investment decision not to invest in the country.

While global custodians ''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,''[23] the decision to maintain assets with the depository remains closely linked to the decision to invest or continue to invest in the country. Investment decisions are more appropriately the province of the fund's investment adviser or board of directors. Nevertheless, the adviser and the board are in a position to make these decisions only if fully informed of the custody risks by the fund's global custodian. Based on these conclusions, we are amending rule 17f–5 and proposing a new rule designed to create a partnership between a fund adviser and a global custodian in which each performs responsibilities appropriate to its expertise for the purpose of protecting fund assets placed with the foreign depository.

II. Discussion

A. Foreign Bank Custodians: Rule 17f–5

Under our proposal, a fund's use of a foreign bank custodian would continue to be governed by rule 17f–5, as amended in 1997.

We propose to further amend this rule to exclude foreign securities depositories from its coverage,[24] and to make other minor clarifying changes.[25] Compliance with the 1997 Amendments to rule 17f–5 (except for the amended definition of Eligible Foreign Custodian) will continue to be suspended until we complete consideration of new rule 17f–7.[26] We request comment on whether any further amendments to rule 17f–5 are necessary.

When a depository custody arrangement involves a foreign bank subcustodian that participates in the depository, rule 17f–5 would continue to apply to the global custodian's use of the foreign bank subcustodian, while proposed rule 17f–7 would apply to the foreign bank subcustodian's use of the depository itself.[27] Is the interaction between rule 17f–5 and proposed rule 17f–7 in regulating these respective custody arrangements sufficiently clear? If not, what further clarification is needed?

B. Foreign Securities Depositories: Proposed Rule 17f–7

Proposed rule 17f–7 would govern custody arrangements with foreign securities depositories. Funds usually deal with these depositories through a ''Primary Custodian'' (also often referred to as a ''global custodian''), which the rule would define as a U.S. Bank or Qualified Foreign Bank (under rule 17f–5) that contracts directly with the fund to provide custodial services for foreign assets.[28] As discussed below, the rule would assign particular duties to the Primary Custodian.

1. Eligible Securities Depository

Under the proposed rule, funds or their custodians could maintain their assets with a securities depository only if it is an ''Eligible Securities Depository.'' An Eligible Securities Depository must function as a system for the central handling of securities, and must be regulated by a foreign financial regulatory authority.[29] The Commission also is proposing four additional minimum requirements, which were suggested to us by representatives of funds and bank custodians. To be an Eligible Securities Depository under rule 17f–7, a depository must, among other requirements:

- Hold assets on behalf of the fund under conditions no less favorable than those that apply to other participants;
- Maintain records identifying the assets of each participant and keep its own assets separated from those of the participants;
- Provide periodic reports to participants; and
- Be reviewed periodically by regulatory authorities or independent accountants.[30]

Comment is requested on the proposed criteria. Inclusion of these minimum requirements may have the effect of precluding funds from investing in some developing markets in which depositories might fail to meet the criteria. The existence of the rule provisions also may encourage depositories in these markets to meet these requirements. Comment is requested as to their effect on investment in developing markets. Comment also is requested on whether these minimum standards, together with the other protections described below, are sufficient to protect fund assets. With respect to the periodic review requirement, should the rule require review by regulators or auditors to focus on the depository's custodial activities, or to include verifications of assets held? The ICI/Bank Proposal included three other minimum requirements that are not included in proposed rule 17f-7.[31] Should the rule include them? Are

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[21] 1997 Release, *supra* note 3, at text accompanying nn.13–16 and at n.29.

[22] Thus, securities depositories were included in the ''selection process'' of rule 17–5, as amended in 1997. *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) (placed in File No. S7–15–99).

[23] *See* Revised ICI/Bank Proposal, *supra* note 16, Attachment 3 at 3.

[24] A proposed note to rule 17f–5 would clarify that custody arrangements involving securities depositories would be governed by rule 17f–7 and by relevant provisions of rule 17f–5, which would remain applicable to foreign bank subcustodians participating in these arrangements. Rule 17f–7 would include a similar note.

[25] The amendments would use the term ''foreign assets'' in place of ''fund assets'' for convenience, and to clarify that assets maintained with a foreign custodian may not be the exclusive property of the fund. *See* Uniform Commercial Code, Revised Article 8, section 8–503(b) and comment 1 (entitlement holder's property interest in securities held by its securities intermediary is a pro rata interest shared with other customers of the intermediary).

The amendments also would refer to ''maintaining assets with'' an eligible foreign custodian rather than ''selecting'' a custodian, and would use the term ''eligible foreign custodian'' throughout the rule. In addition, the amendments would note that the fund's foreign custody manager, as well as the fund itself, may place and maintain fund assets with an eligible foreign custodian. *See* proposed rule 17f–5.

[26] *See* ''Supplementary Information'' section *supra*; Custody of Investment Company Assets Outside the United States; Extension of Compliance Date, Investment Company Act Release No. 23814 (Apr. 29, 1999); Custody of Investment Company Assets Outside the United States, Investment Company Act Release No. 23670 (Jan. 28, 1999) (64 FR 5156 (Feb. 3, 1999)); *see also supra* note 14.

[27] *See supra* note 24.

[28] Proposed rule 17f–7(b)(2).

[29] Proposed rule 17f–7(b)(1)(i) and (ii). The definition of an Eligible Securities Depository would combine elements of two related definitions in current rule 17f–5. *See* current rule 17f–5(a)(1)(ii) and (iii) (definitions of certain Eligible Foreign Custodians that are securities depositories or clearing agencies) and (a)(6) (definition of Securities Depository).

[30] Proposed rule 17f–7(b)(1)(iii) to (vi). The proposed requirements address five of the requirements suggested in the ICI/Bank Proposal. *See supra* note 16.

[31] The ICI/Bank Proposal also required that (i) no foreign regulators have issued public statements

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there other minimum requirements that funds or their custodians typically insist on before placing assets with a depository? Instead of the proposed approach, should the definition state generally that a depository should meet minimum reasonable commercial standards, and then specify some but not all applicable requirements?

In some foreign securities markets, transfer agents or similar entities may perform custodial functions analogous to those of a depository. For example, an Australian central electronic subregistry may effectively function as a central transfer agent that performs custody functions in a manner similar to a depository.[32] In Russia and other countries such as the Ukraine, registrars for each issuer may perform analogous custody functions.[33] The proposed amendments would define an Eligible Securities Depository to include a transfer agent that, among other things, transfers and holds uncertificated securities on the books of an issuer for market participants.[34] The transfer agent would have to be regulated by a foreign financial regulatory authority, and meet other minimum standards for securities depositories as discussed above.

The Commission requests comment on the proposed expansion of the definition of an Eligible Securities Depository. Is it appropriate to treat transfer agents as Eligible Securities Depositories in these circumstances? Should other requirements be added if a transfer agent is to be treated as a depository? To avoid confusion about whether a transfer agent performs all of the functions of a depository, should the rule define a broader type of entity, such as an ''eligible securities holding facility,'' and permit funds to maintain foreign assets with either a depository or a transfer agent that qualifies as this type of facility? In the alternative, should the rule omit any provision for the use of foreign transfer agents, and require funds and custodians to seek approval for their use on a case-by-case basis?

2. Risk-Limiting Conditions

Proposed rule 17f–7 would provide two alternative approaches to managing the custody risks that funds may face when they maintain assets with an Eligible Securities Depository.

a. Indemnification or Insurance

Under the first alternative, a fund could obtain indemnification or insurance that adequately protects it against *all custody risks* of using the depository.[35] A fund would be ''adequately protected'' under this provision by an agreement with or policy issued by a reliable party to compensate the fund for any custody losses arising from use of the depository.[36] A fund could rely on this alternative with respect to all of its assets maintained in foreign securities depositories or with respect to assets held by a particular depository.[37]

This alternative would recognize that a fund that is indemnified or insured against all custodial losses of a depository arrangement is not exposed to the risks of using the depository (which are transferred to the indemnifying or insuring party), and therefore the risk analysis, monitoring, and notification requirements discussed below may not be necessary. The Commission requests comment on this approach. Should the rule define the types of custody risks that should be covered? Should the rule specify how the fund would determine that indemnification or insurance is adequate to protect the fund against all losses attributable to custody risks? Are there any reasons why indemnification or insurance could not cover all custody risks? Should the rule permit a determination that more limited coverage may be adequate in some circumstances?

b. Risk Analysis, Monitoring, and Notification

Under the second alternative, the fund's contract with its Primary Custodian must require the custodian to provide the fund or its investment adviser an initial risk analysis of the custody risks of using a depository before the fund places its assets with the depository.[38] The contract also must require the Primary Custodian to continuously monitor these custody risks and promptly notify the fund or its investment adviser of any material change.[39] These provisions are designed to allocate responsibilities for overseeing the safety of fund assets to the parties best suited to the tasks involved.

In earlier commentary on rule 17f–5, representatives of funds argued that because of global custodians' expertise and their contractual relationships with depositories or their participants, custodians were in a better position to make findings regarding the use of depositories.[40] Global custodians disagreed, arguing that the decision to use a depository, because it is often a prerequisite for participation in a particular foreign market, is an

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indicating that the depository has not complied with financial strength requirements or (ii) internal controls requirements, unless the problem has been cured, and (iii) that the custodian for the fund has agreed to comply with the depository's requirements.

[32] Thomas Murray Ltd, Central Securities Depositories Guide 1997 at 49. The Australian ''CHESS'' system supplements issuers' own share registers. It records market transactions as transfers of legal ownership on the issuer's records. Although local law may not treat CHESS as a custodian, CHESS may effectively perform custodial functions by holding definitive evidence of the ownership of securities that do not exist in certificate form *Cf.* ASX Settlement and Transfer Corporation Pty Ltd, SEC No-Action Letter (Apr. 19, 1994) (suggesting that CHESS system may not perform custodial functions); rule 17f–4(a) under the Investment Company Act (17 CFR 270.17f–4(a)) (defining a 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 the securities).

[33] *See* Thomas Murray Ltd. Worldwide Securities Market Report (19)97, at 247 (1996). In Russia, equity securities are generally uncertificated, and entries on the registrar's books are generally recognized as the only binding evidence of the ownership of securities. The registrar may effectively act as a custodian by holding definitive evidence of the ownership of securities that are uncertificated. *See* Templeton Russia Fund, Inc., SEC No-Action Letter (Apr. 18, 1995) (Suggesting that registrars may be limited participants in the custodial process).

[34] Proposed rule 17f–7(b)(1); *cf.* American Pension Investors Trust, SEC No-Action Letter (Feb. 1, 1991) (custodian for fund of funds could maintain fund's investment in uncertificated shares of underlying funds with the domestic transfer agents of those funds acting as deemed depositories); FundVest, SEC No-Action Letter (Nov. 21, 1984) (similar position).

[35] Proposed rule 17f–7(a)(1). Potential custody risks of using a depository might include, for example, faults in recordkeeping systems or securities handling procedures or systems for distributing losses among participants. *See infra* text accompanying notes 44 to 48 (list of factors that may be relevant to custody risks).

[36] Current rule 17f–5 requires a contract with a foreign custodian to provide for indemnification or insurance (or equivalent protections) that adequately protect the fund against the loss of assets held under the contract. Rule 17f–5(c)(2)(i)(A) and (ii): *see also* 1997 Release, *supra* note 3, at text accompanying n.27 (foreign custody manager itself may have obligation to indemnify the fund in some circumstances). The rule provision has been interpreted to bind the primary custodian globally unless each subcustodian satisfies it individually, and to extend to all foreseeable risks of loss. Investment Company Institute, SEC No-Action Letter, at nn. 1–2 and accompanying text (Nov. 4, 1987). In contrast, the first alternative, discussed in the text above, would require coverage of all custody losses.

[37] Protection available from the depository itself, such as a depository guarantee fund, normally would not protect a beneficial owner such as the fund, and may provide only for sharing or partial reimbursement of losses. A government guarantee of a depository may suffice if the guarantee is complete and extends to beneficial owners as well as depository participants.

[38] Proposed rule 17f–7(a)(2)(i)(A). *Cf.* United Kingdom Securities and Futures Authority, Board Notice 433, New Safekeeping Rules, Custody Rule 4–107(1), Assessment of Custodian (July 21, 1997) (''U.K. Custody Rule 4–107(1)'') (before a custodial firm or an arranger of custodial services holds a safe custody investment with an eligible custodian, it must undertake an appropriate risk assessment of the custodian).

[39] Proposed rule 17f–7(a)(2)(i)(B). *Cf.* U.K. Custody Rule 4–107(1), *supra* note 38 (after firm makes an appropriate risk assessment of the eligible custodian, it must undertake a continuing risk assessment).

[40] *E.g.*, Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission, from Craig S. Tyle, Vice President & Senior Counsel, Investment Company Institute at 1, 3–4 (July 26, 1996) (place in File No. S7–15–99).

investment decision more properly made by the fund or its investment adviser.[41] Each of these views has merit and contributes to our proposed rule.

Proposed rule 17f–7 would assign to the fund's Primary Custodian the responsibility to analyze and monitor the risks of using the depository, under an approach that reflects provisions that many custodial agreements may already contain.[42] The Primary Custodian also would be required to agree to exercise reasonable care and diligence in performing these and other responsibilities, as discussed below, but would not be required to make specific findings under the rule. Its obligations under the required contractual provisions would be generally fulfilled by providing the adviser with an initial analysis and an ongoing assessment of the custody risks associated with the use of the depository. A local subcustodian or other agent could prepare the risk analysis on behalf of the Primary Custodian.[43]

The risk analysis requirements of the proposed rule are written broadly to provide custodians with flexibility to tailor the risk analysis in proportion to the risks involved in the use of each particular depository. We would expect, for example, the Primary Custodian to provide a more detailed analysis of a less established depository than of a depository with an extensive operating history. To facilitate the flexible application of the rule's requirements to different depository arrangements, the proposed rule does not specify particular types of risk that the custodian should analyze, monitor, and report.

As a general matter, we would expect that a custodian's analysis could include a discussion of the depository's expertise and market reputation, quality of services, financial strength,[44] insurance arrangements, extent and quality of regulation or other independent examination,[45] standing in published ratings,[46] internal controls and other procedures for safeguarding investments,[47] and related legal protections. Comment is requested on whether the rule should specifically require the analysis to cover these or other areas.[48]

Proposed rule 17f–7 would not assign a particular role to the investment adviser or fund board, although it assumes that the investment adviser would generally determine whether to place fund assets with a depository under the general oversight of the fund board. The rule is designed to assure that sufficient material information about depositories is provided to the adviser in a timely manner. Decisions regarding whether to place fund assets with a depository would be made by the adviser or board based on standards of care that are generally applicable to fund advisers and directors.[49] These standards generally require the exercise of care, but do not strictly limit the risks that may be acceptable in depository arrangements in appropriate circumstances.[50]

Fund boards do not typically have the expertise to make day-to-day decisions regarding foreign depository arrangements.[51] Therefore, we assume (but the rule does not require) that a fund board would delegate this responsibility to the fund's adviser, subject to the board's general oversight. Fund boards play an important role, however, in deciding whether to invest in or exit the markets of a particular country.[52] When custodial risks are a material factor in a decision to enter or exit a market, we would expect the adviser to inform the board of the risks based on analysis provided by the Primary Custodian.[53] The rule does not require, nor would we expect, fund boards to continue to be provided with the lengthy and detailed briefing books they often receive today.

The Commission requests comment on the proposed provisions relating to risk analysis, monitoring, and notification requirements. Should the rule permit a fund to use a primary custodian that is also a securities depository [54] If it does, should the rule require the primary custodian/depository to prepare the initial analysis of the custody risks of its own custody arrangements (including arrangements with its subcustodians) and to monitor the risks [55] Should the rule require another person to prepare the analysis and monitor the risks? For example, should the rule require the fund's investment adviser to retain an independent custody consultant to analyze and monitor the risks of any depository arrangement in which the fund's primary custodian is itself the depository?

c. Exercise of Care

Proposed rule 17f–7 also would require under the second alternative that the fund's contract with its Primary Custodian provide that the Primary Custodian, and each bank subcustodian

[41] *E.g.,* Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission, from Daniel L. Goelzer, Baker & McKenzie at 3–5 (June 7, 1996) (place in File No. S7–15–99).

[42] *See e.g.,* Amendment No. 2 to Custody Agreements between Templeton Funds and The Chase Manhattan Bank (July 23, 1998), filed with Templeton Funds Inc. Form N–1A, Post-Effective Amendment No. 31 (Oct. 29, 1998) (custodian would monitor compulsory depositories and advise fund of any material negative change in the performance of, or arrangements with, any compulsory depository that would adversely affect the custody of assets); *see also* Revised ICI/Bank Proposal, *supra* note 16 (suggesting that foreign custody manager monitor whether any material change has occurred in fund custody arrangements with depository).

[43] Proposed rule 17f–7(a)(2)(i).

[44] Representatives of funds and bank custodians suggest that capital may not be a reliable gauge of financial strength because depository capital levels vary widely. *See* June 1998 Letter, *supra* note 13 (accompanying appendix). Other measures of depository financial strength that may be more significant include the level of depository settlement guarantee funds, collateral requirements, lines of credit, or insurance, as compared with participants' daily settlement obligations. *See* Gary Stephenson, *Emerging Market Depositories: What to Look For,* at 6 (speech delivered in Bermuda on May 4, 1998) (place in File Not. S7–15–99).

[45] This factor relates to requirements in the definition of an Eligible Securities Depository.

[46] These ratings may include evaluations or survey information published by sources such as *Global Custodian* or Thomas Murray Ltd, or more formal ratings of depositories that may be available.

[47] This factor related to requirements in the definition of an Eligible Securities Depository.

[48] *See generally* U.K. Custody Rule 4–107(1), *supra* note 38 (cites seven analogous factors to be considered in undertaking continuing risk assessments).

[49] *See, e.g.,* Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979) (section 206 of the Investment Advisers Act (15 U.S.C. 80b–6) imposes fiduciary duties on investment advisers); *Burks* v. *Lasker,* 441 U.S. 471 (1979) (Investment Company Act entrusts independent directors with responsibility to furnish an independent check on management); American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 4.01 (1994) (discussing duties of directors and officers under state law, including duties of care and inquiry).

[50] *See id.* The primary custodian's analysis and continuous monitoring of risks may help to provide an ''early warning system'' concerning a depository custody arrangement that presents more risks than other arrangements.

[51] *See* SEC, Division of Investment Management, Protecting Investors: A Half Century of Investment Company Regulation 270 n. 78 (1992).

[52] *See* 1997 Release, *supra* note 3, at n. 20 and accompanying text.

[53] The Commission would expect that the primary custodian also would continue to provide other information relating to country risk and other investment risks. *See id.* at nn. 18–20 and accompanying text.

[54] Some foreign depositories may permit funds to use their services directly as clients or participants. *See* Simon Thomas and Simon Murray, Global Securities Services: The Institutional Investors' Guide 55, 90 (1995) (Euroclear has altered its rules to permit fund mangers to participate); *see generally* rule 17f–4(c) under the Investment Company Act (17 CFR 270.17f–4(c)) (permitting a fund to participate directly in a domestic depository, subject to certain conditions); Midwest Securities Trust Company, SEC No-Action Letter (Mar. 14, 1990) (fund that participates directly in a depository may maintain a cash account to facilitate settlement of transactions or to secure obligations to a reserve fund to cover participant defaults).

[55] A foreign depository may itself maintain securities with other depositories. *See* Richard Dale, *Clearing and Settlement Risks in Global Securities Markets: The Case of Euroclear,* Journal of Business Law 434, 445 (Sept. 1998).

in its network involved in a depository arrangement, will agree to exercise reasonable care, prudence, and diligence in performing its duties under the rule and in all other conduct relating to the custodial arrangements, or to adhere to a higher standard of care.[56] The proposed standard of care is the same required of foreign custody managers under rule 17f–5,[57] and similar to standards for U.S. custodians under commercial law.[58]

C. Request for Comment on Other Issues

The Commission requests comment on possible additional changes to rule 17f–5 and proposed rule 17f–7. For example, should the Commission consider adapting the proposed requirements for the use of a depository to apply to the use of a bank subcustodian as well, and eliminate the separate requirements for the use of a bank subcustodian? Because the fund's Primary Custodian would likely act as its foreign custody manager in most cases,[59] should the Commission simply eliminate provisions that require the appointment of a foreign custody manager, and allocate related responsibilities directly to the Primary Custodian? Alternatively, should the Commission not adopt the proposed amendments to rule 17f–5 and proposed rule 17f–7, and instead revise the compliance date for the 1997 Amendments to allow funds to contract with global custodians that accept the responsibilities described in current rule 17f–5? Is there any need to address matters outside the scope of the proposed amendments, such as the handling of cash, or the use of affiliated custodians or subcustodians?

The Commission requests comment on the new rule and rule amendments proposed in this Release, suggestions for additional provisions or changes to existing rules or forms, and comments on other matters that might have an effect on the proposals contained in this Release. The Commission also requests comment whether the proposals, if adopted, would promote efficiency, competition, and capital formation. Comments will be considered by the Commission as it satisfies its responsibilities under section 2(c) of the Investment Company Act.[60] For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[61] the Commission also requests information regarding the potential impact of the proposals on the U.S. economy on an annual basis. Commenters are requested to provide empirical data to support their views.

III. Cost-Benefit Analysis

The Commission is sensitive to the costs and benefits that result from its rules. The proposed amendments to rule 17f–5 and proposed new rule 17f–7 respond to concerns expressed by global custodians and fund managers that rule 17f–5, as amended in 1997, is not workable. The proposals also address fund managers' concerns that, as a result of global custodians' unwillingness to assume delegated responsibilities under rule 17f–5, obligations to evaluate depositories' custodial capabilities may fall to fund boards, which lack the relevant knowledge and expertise to make these evaluations.

Proposed rule 17f–7 should benefit funds and their investors by establishing a workable framework designed to require global custodians, which are in the best position to monitor and evaluate risks of foreign depositories, to assume these responsibilities. The rule also should benefit funds and their shareholders by freeing fund boards of the responsibility to make findings concerning foreign depositories that often remained with them after the 1997 Amendments because of global custodians' refusals to accept delegated responsibility. As a result, fund boards should have more time to address other issues that are important to investors.

The proposed rule and rule amendments may impose costs. Although the proposed rule sets minimum requirements for depositories, its lack of a maximum standard for custody risks could cause losses to investors if a depository fails, despite diligent performance by global custodians and advisers of their responsibilities. Because the rule does not limit maximum custody risks in depository arrangements, additional prospectus disclosure may be required where it may be necessary for investors to evaluate the risks and rewards of investing in the fund.[62] The Commission requests comment on the costs and benefits of current rule 17f–5, including its requirement that a foreign custody manager determine that assets maintained with a depository will be subject to reasonable care, as compared with the costs and benefits of proposed rule 17f–7's provisions that do not set limits on potential depository custody risks.

Global custodians should not incur materially greater costs under proposed rule 17f–7, which generally would require them to perform duties they typically perform already under custodial contracts. The rule may have the effect of requiring global custodians to exercise a greater degree of vigilance in monitoring depositories (or to refrain in the future from reducing their diligence) and in this respect may impose costs. Such costs are necessary, however, for the protection of funds consistent with the purposes of sections 6(c) and 17(f) of the Investment Company Act. We expect that global custodians will pass on any additional costs to mutual funds, but that the costs are unlikely to materially affect overall fund expense ratios.

Fund managers may bear the cost of evaluating the information provided by global custodians and making decisions regarding the continued use of a depository (and in this respect, continued investment in the country). We believe that in the context of foreign depository arrangements, this allocation of costs is appropriate in light of (i) the unwillingness of global custodians to assume responsibilities that may overlap with investment decisions and (ii) the extent to which the decision to use a foreign depository may affect an investment strategy that contemplates investment in a particular foreign market. Advisers to funds could pass on this responsibility to directors, but this result would not be mandated by the proposals, and fund directors would be free to reject this responsibility.

The Commission requests comment on the potential costs and benefits associated with the proposed amendments and proposed rule, and on any suggested alternatives to the proposals.[63] Specific comment is

[56] Proposed rule 17f–7(a)(2)(ii).

[57] Rule 17f–5(b)(3); *see* proposed rule 17f–5(b)(3) (same requirement); Revised ICI/Bank Proposal, *supra* note 16, Attachment 3 at 5 (''(c)onsistent with that (reasonable care) standard, an FCM (foreign custody manager) could not, in our view, place assets with a depository that it knew to be unsafe'').

[58] *See* Uniform Commercial Code, Revised Article 8, sections 8–504 and 8–509 (securities intermediary must perform its duties under Code, including duties to follow procedures in maintaining financial assets and to exercise care in selecting subcustodians, with ''due care in accordance with reasonable commercial standards,'' unless modified by regulatory requirements or contractual provisions that meet ''good faith'' standard).

[59] *See* Revised ICI/Bank Proposal, *supra* note 16, Attachment 3 at 3 (''global custodian banks * * * are most likely to be asked to assume delegated Foreign Custody Manager responsibilities in most cases'').

[60] Section 2(c) of the Investment Company Act (15 U.S.C. 80a–2(c)) requires the Commission, when it engages in rulemaking and is required to consider whether an action is consistent with the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

[61] Pub. L. No. 104–121, Title II, Stat. 857 (1996).

[62] *See* Form N–1A, Item 4(c) (requirement to disclose principal risks of investing in fund).

[63] As noted in Section IV, the Commission's staff estimates a slight reduction in the paperwork

requested on the potential costs or benefits of these proposals for funds and their boards of directors, investment advisers, primary custodians, foreign subcustodians, and depositories. Data is requested concerning these costs and benefits and how they could be quantified and expressed in dollar terms.

IV. Paperwork Reduction Act

Portions of the proposed amendments to rule 17f–5 and proposed new rule 17f–7 contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520), and the Commission is submitting these proposals to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d). The titles of the collections of information are ''Custody of Investment Company Assets Outside the United States'' and ''Custody of Investment Company Assets with a Foreign Securities Depository.'' An agency may not sponsor, conduct, or require responses to an information collection unless it displays a currently valid OMB control number.

A. Proposed Amendments to Rule 17f–5

The proposed amendments to rule 17f–5 would not substantively change the rule's collection of information requirements, which would continue to apply when a fund (*i.e.*, a registered management investment company) maintains its assets with a foreign bank custodian. The amendments would remove custody arrangements with foreign securities depositories from the rule, however, so that the rule's requirements would no longer apply to these custody arrangements. In general, therefore, the proposed amendments would reduce the information collection burdens of rule 17f–5.

The requirements of amended rule 17f–5 that may call for the collection of information would be substantially the same as under the current rule. The fund's board of directors must find that it is reasonable to rely on each delegate it selects to act as the fund's foreign custody manager. The delegate must agree to provide written reports that notify the board when the fund's assets are placed with a foreign custodian and when any material change occurs in the fund's custody arrangements. The delegate must agree to exercise reasonable care, prudence, and diligence, or to adhere to a higher standard of care. When the foreign custody manager selects an eligible foreign custodian, it must determine that the fund's assets will be subject to reasonable care if maintained with that custodian, and that the written contract that governs each custody arrangement will provide reasonable care for fund assets. The contract must contain certain specified provisions or others that provide at least equivalent care. The foreign custody manager must establish a system to monitor the contract and the appropriateness of continuing to maintain assets with the eligible foreign custodian.

The Commission's staff estimates that during the first year after the proposed amendments go into effect, approximately 3,690 fund portfolios [64] would be required to make an average of one response per portfolio under amended rule 17f–5, requiring approximately 2 hours of director time per response, to make the necessary findings concerning foreign custody managers.[65] The total annual burden associated with these requirements of the rule during the first year would be approximately 7,380 hours (3,690 portfolios × 2 hours per portfolio). The staff further estimates that during the first year after the proposed amendments go into effect, approximately 15 global custodians [66] would be required to make an average of 80 responses per custodian concerning the use of foreign custodians other than depositories, requiring approximately 10 hours per response, plus one additional response per custodian that requires approximately 96 hours per response.[67] The total annual burden associated with these requirements of the rule during the first year would be approximately 13,440 hours (15 global custodians × 896 hours per global custodian). Therefore, the total burden of all collection of information requirements of rule 17f–5 during the first year after its amendment is estimated to be approximately 20,820 hours (7,380 + 13,440).[68]

The staff estimates that the proposed amendments' removal of custody arrangements involving securities depositories from rule 17f–5 would eliminate as much as 28,600 additional burden hours currently imposed by the rule's collection of information requirements. This estimate assumes that without the amendments, approximately 650 investment advisers [69] would have to make an average of 3 responses per adviser annually, requiring a total of approximately 44 hours for each adviser, to address depository arrangements.[70]

B. Proposed New Rule 17f–7

Proposed new rule 17f–7 would contain some collection of information requirements. Under the proposed rule, an eligible depository would have to meet minimum standards for a depository.

The fund or its investment adviser would generally determine whether the depository complies with those requirements based on information provided by the fund's primary custodian. The depository custody arrangement also would have to meet certain risk limiting requirements. The fund could obtain indemnification or insurance arrangements that adequately protect the fund against custody risks. The fund or its investment adviser generally would determine whether indemnification or insurance provisions are adequate. If the fund does not rely on indemnification or insurance, the fund's contract with its primary custodian would be required to state

burden. The Commission particularly invites comment on the reasonableness to the staff's burden estimates.

[64] This information is based on data reported by funds on Form N–SAR (17 CFR 274.101).

[65] The staff estimates that these 3,690 portfolios are divided among approximately 1,327 registered funds within approximately 650 fund complexes that may share the same investment adviser, board of directors, U.S. bank custodian, or all of these entities. Each board of directors and its delegates for a fund complex could therefore meet rule 17f–5's requirements by simultaneously approving similar arrangements for some 6 portfolios in the same complex. The estimated hour amounts are based on discussions with representatives of funds about the burden of analogous requirements in another custody rule.

[66] This estimate is based on staff review of custody contracts and other research.

[67] These estimates assume that each of 15 custodians services an average of 250 client portfolios within 40 fund complexes, that a single response by each custodian can simultaneously address approximately 6 client portfolios in a fund complex, and that each custodian makes approximately 80 responses annually requiring 10 hours per response to establish bank custody arrangements for approximately 40 fund complexes and report to their fund boards, and one response annually requiring 96 hours per response to establish a system to monitor custody arrangements for these clients.

[68] The number of responses may decline substantially after the first year because some responses made during that year would suffice for some time thereafter.

[69] *See supra* note 65.

[70] These estimates assume that one adviser manages 6 portfolios, and that each adviser would make 3 responses annually requiring a total of 44 hours to approve depository custody arrangements for each fund complex, report to fund boards, and establish a system to monitor depository arrangements for the fund complex. The 44 hours would include 10 hours spent to establish custody arrangements with depositories and make ''reasonable care'' determinations, 24 hours spent to monitor depository arrangements, and 10 hours spent to report to fund boards.

that the custodian will provide to the fund or its investment adviser a custody risk analysis of each depository, monitor risks on a continuous basis, and promptly notify the fund or its adviser of material changes in risks. The primary custodian and other custodians also would be required to agree to exercise reasonable care.

The staff estimates that during the first year after proposed rule 17f–7 goes into effect, approximately 650 investment advisers would make an average of 3 responses per adviser under the proposed rule, requiring a total of approximately 25 hours for each adviser, to address depository compliance with minimum requirements, any indemnification or insurance arrangements, and reviews of risk analyses or notifications.[71] The total annual burden associated with these requirements of the rule during the first year would be approximately 16,250 hours (650 advisers × 25 hours per adviser). The staff further estimates that during the first year after the proposed rule goes into effect, approximately 15 global custodians would make an average of 80 responses per custodian under the rule that would require approximately 10 hours per response.[72] The total annual burden associated with these requirements of the new rule would be approximately 12,000 hours (15 custodians × 800 hours). Therefore, the total annual burden associated with all collection of information requirements of the proposed new rule during the first year after its adoption is estimated to be 28,250 hours (16,250 + 12,000).

As reflected in the following summary of the burden hour requirements of the collection of information requirements in current rule 17f–5, rule 17f–5 as proposed to be amended, and proposed rule 17f–7, the staff estimates that the net effect of the proposed amendments and new rule may be to reduce the total annual paperwork burden by 350 hours:

Rule	Paperwork burden hours
Current rule 17f–5	49,420
Rule 17f–5 as proposed to be amended	20,820
Proposed rule 17f–7	28,250
Net reduction	−350

The Commission requests comment on the reasonableness of these estimates. Commenters who disagree are requested to provide their own estimates with supporting rationales.

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (i) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the staff's estimate of the burden of the proposed collections of information; (iii) enhance the quality, utility and clarity of the information to be collected; and (iv) minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements of the proposed amendments and proposed rule should direct them to the following persons: (i) Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Office of Management and Budget, Room 3208, New Executive Office Building, Washington, DC 20503; and (ii) Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street NW, Washington, DC 20549–0609, with reference to File No. S7–15–99. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication; therefore, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release. Requests for materials submitted to OMB by the Commission with respect to these collections of information should be in writing, refer to File No. S7–15–99, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services.

V. Summary of Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (''IRFA'') in accordance with 5 U.S.C. 603 regarding the proposed amendments to rule 17f–5 and proposed new rule 17f–7, and conforming amendments to rules 7d–1 and 17f–4. The following summarizes the IRFA.

A. Reasons for the Proposed Action

Rule 17f–5 governs the custody of the assets of registered management investment companies (''funds'') with custodians outside the United States. The Commission amended the rule in 1997 to modernize its conditions. In 1998, representatives of funds and bank custodians informed the Commission that some conditions of the rule presented problems regarding the use of foreign securities depositories.

B. Objectives

The Commission is proposing amendments to rule 17f–5 and a new rule 17f–7, which together would permit funds to maintain their assets in foreign securities depositories based on conditions that reflect the operations and role of these depositories. The proposed amendments to rule 17f–5 would remove custody arrangements with foreign securities depositories from the rule, eliminating the applicability to depository arrangements of requirements that certain findings be made by the fund board, its investment adviser, or global custodian, and that certain specified terms or equivalent protections appear in the rules of the depository.

Proposed new rule 17f–7 would establish new provisions for the use of depositories. The proposed rule would require every foreign securities depository that holds fund assets to meet specified minimum standards for depositories. The proposed rule also would require a custody arrangement with a depository to meet either of two alternative sets of risk-limiting conditions. Under one alternative, the fund could obtain adequate indemnification or insurance against the custody risks of depository arrangements. Under the other alternative, the fund's contract with its primary custodian would have to state that the custodian will provide the fund or its adviser an initial analysis of the custody risks of the depository arrangement, continuously monitor those risks, and notify the fund or its adviser of material changes in the risks. The primary custodian and other custodians involved in the depository

[71] These estimates assume that one adviser manages 6 portfolios, and that each adviser would make 3 responses annually requiring a total of 25 hours for each adviser to address depository compliance with minimum requirements, any indemnification or insurance arrangements, and reviews of risk analyses or notifications for the adviser's fund complex. The 25 hours would include 3 hours spent to verify depository compliance with minimum requirements, 2 hours spent to address any indemnification or insurance arrangements, and 20 hours spent to review risk analyses or notification for the fund complex.

[72] These estimates assume that each of 15 custodians services an average of 250 client portfolios within 40 fund complexes, that a single response by each custodian can simultaneously address approximately 6 client portfolios in a fund complex, and that each custodian makes approximately 80 annual responses requiring 10 hours per response to prepare risk anslyses of depository arrangements and monitor risks for approximately 40 fund complexes, and to provide notices of material changes in risks to these clients.

arrangement also would have to agree to exercise reasonable care in performing these duties and in other conduct relating to custody arrangements. The conforming amendments to rules 7d–1 and 17f–4 would clarify current references to rule 17f–5 by adding a reference to rule 17f–7 as well.

C. Legal Basis

The Commission is proposing the amendments to rule 17f–5 and new rule 17f–7 and conforming amendments to rules 7d–1 and 17f–4 pursuant to the authority set forth in sections 6(c), 7(d), 17(f), and 38(a) of the Investment Company Act (15 U.S.C. 80a–6(c), –7(d), –17(f), and –37(a)).

D. Small Entities Subject to the Rules

The proposed amendments and new rule will affect, among other persons, the approximately 15 global custodians that act as foreign custody managers for funds under rule 17f–5 and as primary custodians under proposed rule 17f–7. None of these global custodians would likely qualify as a small entity, because each custodian is a major bank with a global branch network or global ties to other banks. The proposed amendments and new rule also will affect the funds that invest in foreign markets and their investment advisers. Few if any of the affected funds and advisers would be small entities.[73]

On balance, the impact of the proposed amendments and new rule on global custodians, funds, and advisers is not expected to be great, because the burdens of the new rule's requirements would be offset in part by the elimination of burdens under existing rule 17f–5. For this reason, and because few if any of the affected entities would qualify as small entities, the proposed amendments are unlikely to have a significant impact on a substantial number of small entities.

E. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed amendments to rule 17f–5 would retain existing reporting, recordkeeping, and other compliance requirements of the rule without substantive changes, insofar as they apply to custody arrangements with a foreign bank custodian. The amendments would remove a custody arrangement with a foreign depository from the rule, eliminating the necessity for it to comply with these requirements.

Proposed new rule 17f–7 would establish new requirements for arrangements with depositories. As described above, the new rule would require each foreign securities depository that holds fund assets to meet certain specified minimum requirements. Depository arrangements also would have to meet other risk-limiting conditions. A fund could obtain adequate indemnification or insurance against the custody risks of depository arrangements. In the alternative, the fund's contract with its primary custodian would have to state that the custodian will provide an analysis of depository custody risks, continuously monitor the risks, and promptly notify the fund of any material changes in risks. The primary custodian and other custodians also would have to agree to exercise reasonable care in all conduct relating to custody arrangements.

F. Significant Alternatives

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant economic impact on small entities. As discussed above, none of the global custodians affected by the proposed amendments to rule 17f–5 or proposed rule 17f–7, and few if any of the affected funds and advisers, are likely to be considered small entities for purposes of the Regulatory Flexibility Act. As further discussed above, the impact of the amendments is likely to be limited, because burdens under the proposed new rule would be offset in part by reduced burdens under current rule 17f–5. Therefore, the potential impact of the amendments and the proposed new rule on small entities would not be significant.

For these reasons, alternatives to the proposed amendments and proposed new rule are unlikely to minimize any impact that the proposed amendments may have on small entities. Alternatives in this category would include: (1) Establishing different compliance or reporting standards that take into account the resources available to small entities; (2) clarifying, consolidating or simplifying the compliance requirements for small entities; (3) using performance rather than design standards; and (4) exempting small entities from coverage of all or part of the rule.

The Commission encourages the submission of comments on matters discussed in the IRFA. Comment specifically is requested on the number of small entities that would be affected by the proposals and the impact of the proposals on small entities. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. These comments will be placed in the same public comment file as comments on the proposals. A copy of the IRFA may be obtained by contacting Thomas M.J Kerwin, Securities and Exchange Commission, 450 5th Street, NW, Washington, DC 20549–0506.

VI. Statutory Authority

The Commission is proposing amendments to rule 17f–5 and new rule 17f–7 and conforming amendments to rules 7d–1 and 17f–4 pursuant to authority set forth in sections 6(c), 7(d), 17(f), and 38(a) of the Investment Company Act (15 U.S.C. 80a–6(c), –7(d), –17(f) and –37(a)).

List of Subjects in 17 CFR Part 270

Investment companies, Reporting and recordkeeping requirements, Securities.

Text of Proposed Rule

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The general authority citation for part 270 continues to read in part as follows:

Authority: 15 U.S.C. 80a–1 *et seq.*, 80a–34(d), 80a–37, 80a–39 unless otherwise noted:

* * * * *

2. Section 270.7d–1 is amended by revising the introductory text of paragraph (b)(8)(v) to read as follows:

§ 270.7d–1 Specification of conditions and arrangements for Canadian management investment companies requesting order permitting registration.

* * * * *

(b) * * *

(8) * * *

(v) Except as provided in § 270.17f–5 and § 270.17f–7, applicant will appoint, by contract, a bank, as defined in section 2(a)(5) of the Act (15 U.S.C. 80a–2(a)(5)) and having the qualification described in section 26(a)(1) of the Act (15 U.S.C. 80a–26(a)(1)), to act as trustee of, and maintain in its sole custody in the United States, all of applicant's securities and cash, other than cash

[73] A fund is consisered a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less. 17 CFR 270.0–10. An adviser is considered a small entity if it has assets under management of less than $25 million, has total assets of less than $5 million, and is not in a control relationship with other advisers or persons that are not small entities. 17 CFR 275.0–7. Most funds that invest in foreign securities are part of a fund complex that holds net assets of more than $50 million, and are advised by advisers with assets under management of $25 million or more.

necessary to meet applicant's current administrative expenses. The contract will provide, *inter alia,* that the custodian will:

* * * * *

3. Section 270.17f–4 is amended by revising the introductory text of paragraph (b) to read as follows:

§ 270.17f–4 Deposits of securities in securities depositories.

* * * * *

(b) A registered management investment company (investment company) or any qualified custodian may deposit all or any part of the securities owned by the investment company in a foreign Eligible Securities Depository as defined in § 270.17f–7 in accordance with the provisions of § 270.17f–7 and applicable provisions of § 270.17f–5, or in:

* * * * *

4. Section 270.17f–5 is revised to read as follows:

§ 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 a Qualified Foreign Bank or a majority-owned direct or indirect subsidiary of a U.S. Bank or bank-holding company.

(2) *Foreign Assets* means any investments (including foreign currencies) for which the primary market is outside the United States, and any cash and cash equivalents that are reasonably necessary to effect the Fund's transactions in those investments.

(3) *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.

(4) *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.

(5) *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.

(6) *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.

(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) 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 Foreign Assets with a particular custodian and of any material change in the Fund's foreign custody 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 arrangements; and

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

(c) *Maintaining Assets with an Eligible Foreign Custodian.* A Fund or its Foreign Custody Manager may place and maintain the Fund's Foreign Assets in the care of an Eligible Foreign Custodian, *provided that:*

(1) *General Standard.* The Foreign Custody Manager determines that the Foreign 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, after considering all factors relevant to the safekeeping of the Foreign Assets, including, without limitation:

(i) The Eligible Foreign 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 Eligible Foreign Custodian has the requisite financial strength to provide reasonable care for Foreign Assets;

(iii) The Eligible Foreign Custodian's general reputation and standing; and

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

(2) *Contract.* The arrangement with the Eligible Foreign Custodian is governed by a written contract that the Foreign Custody Manager has determined will provide reasonable care for Foreign Assets based on the standards specified in paragraph (c)(1) of this section.

(i) The contract must provide:

(A) For indemnification or insurance arrangements (or any combination) that will adequately protect the Fund against the risk of loss of Foreign Assets held in accordance with the contract;

(B) That the Foreign Assets will not be subject to any right, charge, security interest, lien or claim of any kind in favor of the Eligible Foreign 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) That beneficial ownership of the Foreign Assets will be freely transferable without the payment of money or value other than for safe custody or administration;

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

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

(F) That the Fund will receive periodic reports with respect to the safekeeping of the Foreign 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) The contract may contain, in lieu of any or all of the provisions specified

in paragraph (c)(2)(i) of this section, other provisions that the Foreign Custody Manager determines will provide, in their entirety, the same or a greater level of care and protection for the Foreign Assets as the specified provisions, in their entirety.

(3)(i) *Monitoring the Foreign Custody Arrangements.* The Foreign Custody Manager has established a system to monitor the appropriateness of maintaining the Foreign Assets with a particular custodian under paragraph (c)(1) of this section, and to monitor performance of the contract under paragraph (c)(2) of this section.

(ii) If an arrangement with an Eligible Foreign Custodian no longer meets the requirements of this section, the Fund must withdraw the Foreign Assets from the Eligible Foreign Custodian as soon as reasonably practicable.

(d) *Registered Canadian Funds.* Any Registered Canadian Fund may place and maintain its Foreign Assets outside the United States in accordance with the requirements of this section, *provided that:*

(1) The Foreign 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.

Note to § 270.17f–5: A custody arrangement that involves an Eligible Securities Depository (as defined in § 270.17f–7) would be governed by the provisions of § 270.17f–7 as well as by provisions of § 270.17f–5 that apply to any Eligible Foreign Custodian involved in the depository custody arrangement.

5. Section 270.17f–7 is added to read as follows:

§ 270.17f–7 Custody of investment company assets with a foreign securities depository.

(a) *Custody arrangement with an Eligible Securities Depository.* A Fund, including a Registered Canadian Fund, may place and maintain its Foreign Assets with an Eligible Securities Depository, *provided that:*

(1) *Indemnification or insurance.* The Fund has obtained indemnification or insurance arrangements (or any combination) that will adequately protect the Fund against all losses attributable to the custody risks associated with maintaining assets with the Eligible Securities Depository; or (2)

(2) *Alternative safeguards.* The custody arrangement provides other reasonable safeguards against the custody risks associated with maintaining assets with the Eligible Securities Depository, including:

(i) *Risk analysis and monitoring.* The Fund's contract with its Primary Custodian states that the Primary Custodian (or its agent) will:

(A) Provide the Fund or its investment adviser with an analysis of the custody risks associated with maintaining assets with the Eligible Securities Depository, before the Fund places its assets with the depository; and

(B) Continuously monitor the custody risks associated with maintaining assets with the Eligible Securities Depository and promptly notify the Fund or its investment adviser regarding any material change in these risks.

(ii) *Exercise of care.* The Fund's contract with its Primary Custodian states that the Primary Custodian and each other custodian that acts on behalf of the Fund in maintaining assets with the Eligible Securities Depository will agree to exercise reasonable care, prudence, and diligence in performing the requirements of paragraph (a)(2)(i) of this section and in all other conduct relating to custody arrangements, or to adhere to a higher standard of care.

(3) *Withdrawal of assets from Eligible Securities Depository.* If a custody arrangement with an Eligible Securities Depository no longer meets the requirements of this section, the Fund's Foreign Assets must be withdrawn from the depository as soon as reasonably practicable.

(b) *Definitions.* The terms *Foreign Assets, Fund, Qualified Foreign Bank, Registered Canadian Fund,* and *U.S. Bank* have the same meanings as in § 270.17f–5. In addition:

(1) *Eligible Securities Depository* means a system for the central handling of securities as defined in § 270.17f–4, or a transfer agent that transfers and holds uncertificated securities on the books of an issuer for market participants, that:

(i) Acts as a transnational system for the central handling of securities or equivalent book-entries, or acts as a system for the central handling of securities or equivalent book-entries in the country where it is incorporated or organized;

(ii) 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));

(iii) Holds assets for the custodian that participates in the system on behalf of the Fund under conditions no less favorable than the conditions that apply to other participants;

(iv) Maintains records that identify the assets of each participant and segregate the system's own assets from the assets of participants;

(v) Provides periodic reports to its participants with respect to its safekeeping of assets, including notices of transfers to or from any participant's account; and (vi) Is subject to periodic review by regulatory authorities or independent accountants.

(2) *Primary Custodian* means a U.S. Bank or Qualified Foreign Bank that contracts directly with a Fund to provide custodial services related to maintaining the Fund's assets outside the United States.

Note to § 270.17f–7: A custody arrangement that involves an Eligible Securities Depository would also be governed by provisions of § 270.17f–5 that apply to any Eligible Foreign Custodian (as defined in § 270.17f–5) involved in the depository custody arrangement.

Dated: April 29, 1999.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 99–11357 Filed 5–5–99; 8:45 am]

BILLING CODE 8010–01–P