

MEMO# 7152

August 1, 1995

SEC PROPOSES AMENDMENTS TO RULE 17F-5 UNDER THE 1940 ACT

1 Investment Company Act Release No. 21259; International Series Release No. 831 (July 27, 1995). 2 See Memorandum to SEC Rules Committee No. 105-94, International Committee No. 17-94, Rule 17f-5 Ad Hoc Committee, dated October 3, 1994. 1 August 1, 1995 TO: CLOSED-END FUND COMMITTEE No. 39-95 INTERNATIONAL COMMITTEE No. 20-95 SEC RULES COMMITTEE No. 88-95 UNIT INVESTMENT TRUST COMMITTEE No. 60-95 RULE 17f-5 AD HOC SUBCOMMITTEE RE: SEC PROPOSES AMENDMENTS TO RULE 17f-5 UNDER THE 1940 ACT

The Securities and Exchange Commission recently issued for public comment proposed amendments to Rule 17f-5, the rule that governs the custody of investment company assets outside of the United States.¹ The Commission's proposal, which reflects many recommendations previously made by the Institute, is summarized below.²

Reasonable Protection of Fund Assets The Commission has proposed amending Rule 17f-5 to remove the current rule's requirement that a fund's foreign custody arrangements be in the best interest of shareholders. Instead, a finding would have to be made that the fund's foreign custody arrangements will provide reasonable protection for fund assets. The Commission stated its belief that the "best interest" standard may be overly broad and difficult for directors to apply and that the proposed "reasonable protection" standard is intended to facilitate evaluations of foreign custody arrangements by focusing exclusively on the safekeeping of fund assets.

Delegation of Board Responsibilities The proposed rule would permit a fund board to delegate its responsibilities under the rule to the fund's investment adviser or officers or a United States or foreign bank. The proposed rule would permit the board to use different delegates for different foreign custody responsibilities and would require the board to find that it is reasonable to rely on the delegate. The proposed rule would not require the board to approve the fund's foreign custodians or other foreign custody matters on an initial or annual basis. Rather, the delegate would be required to provide the board with written reports notifying the board of its selection of a particular custodian and any material changes in the custodial arrangements no later than the next regularly scheduled board meeting following the delegate's actions.

Assessment of A Country's Custodial Risks The proposed rule would require the board's delegate to find that custody of the fund's assets in a particular country can be maintained in a manner that will provide reasonable protection for those assets. The proposed rule would require the delegate to consider all factors relevant to the safekeeping of fund assets, including: (i) the prevailing practices in the country for the custody of the fund's assets; (ii) whether the country's laws will affect adversely the safekeeping of the fund's assets; and (iii) the existence of special arrangements that mitigate the risks of maintaining the assets in the

country. In addition, a fund's delegate would have to consider the use of compulsory depositories as part of the assessment of a country's prevailing custodial risks. Unlike the current rule, the proposed rule would not address the risk of investing in a particular country. For example, a fund's delegate would not be required to consider for purposes of complying with Rule 17f-5 the likelihood of various adverse political events or potential difficulties in converting the fund's cash or cash equivalents to U.S. dollars. The Commission stated its belief that these types of risks should be considered in connection with a determination that a fund should invest in a country, not as part of a custodial determination.

2Selection of Foreign Custodians The proposed rule would require a fund's delegate to find that using a particular custodian will provide reasonable protection for the fund's assets. The rule would require the fund's delegate to consider all factors relevant to the safekeeping of fund assets, including: (i) the custodian's financial strength and its general reputation and standing; (ii) the custodian's practices, procedures, and internal controls; and (iii) whether the fund will have jurisdiction over and be able to enforce judgments against a custodian.

Foreign Custody Contracts The proposed rule would retain the current requirement of a written foreign custody contract, but would not enumerate specific provisions that would have to be included in the contract. Significantly, the rule would no longer require contracts to provide that the fund be indemnified or insured against loss. Rather, the proposed rule would require a finding that the foreign custody contract provide reasonable protection for the fund's assets based on all relevant factors.

Monitoring Custody Arrangements The proposed rule would require the fund's delegate to monitor the continuing appropriateness of the custody of the fund's assets in a country, with a particular custodian, and under the foreign custody contract. If an arrangement no longer provides reasonable protection for fund assets, the proposed rule would require a fund to withdraw its assets as soon as reasonably practicable.

3Eligible Foreign Custodians The proposed rule would include as eligible foreign custodians (i) foreign banks and trust companies that are subject to foreign bank or trust company regulation and (ii) majority-owned foreign subsidiaries of a qualified U.S. bank or a U.S. bank holding company. Unlike the current rule, foreign bank and trust company custodians would not have to satisfy particular capital requirements. The proposed rule, however, would prohibit foreign bank and trust company custodians from being affiliated persons of the fund or affiliated persons of such persons. The proposed rule also includes as an eligible foreign custodian (i) a securities depository or clearing agency that operates a system for the central handling of securities that is regulated by a foreign financial regulatory authority and (ii) a securities depository or clearing agency that operates a transnational system for the central handling of securities.

Disclosure and Unit Investment Trusts Unlike the current rule, the proposed rule would not address the fund's obligation to disclose risks associated with the fund's foreign custody arrangements. In addition, the Commission requested comment on the appropriateness of a rule that would expand the foreign custody arrangements available to unit investment trusts. A copy of the Commission's release proposing the amendments is attached. Comments are due on the proposal by October 6, 1995. The Institute intends to schedule a meeting shortly to discuss the proposal. If you are unable to attend the meeting and have comments that you would like to be included in the Institute's submission, please contact me by September 27, 1995 by phone at (202) 326-5821 or by fax at (202) 326-5827. Dorothy M. Donohue Assistant Counsel Attachment

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